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Court of Appeals
Division II
State of Washington

NO. 50080-9

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

LOWE'S HOME CENTERS, LLC,

Appellant,

v.

DEPARTMENT OF REVENUE, STATE OF WASHINGTON,

Respondent.

BRIEF OF RESPONDENT

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I. INTRODUCTION

The trial court correctly held that Lowe's' tax refund claim is foreclosed by this Court's decision in *Home Depot USA, Inc. v. Dep't of Revenue.*[1] In *Home Depot,* this Court held that RCW 82.08.037 does not entitle a seller to a sales tax refund on bad debts arising from defaulted private label credit card accounts. RCW 82.08.037 applies only to bad debts "directly attributable to" a retail sale. 151 Wn. App. at 922. It does not apply to contractual payments made to a third party lender.

Home Depot is not distinguishable on the ground that Lowe's deducted its payments to GE Capital as bad debts arising from a contractual guarantee rather than as ordinary expenses on its federal income tax returns. Lowe's' bad debt deductions were for amounts it was required to pay in exchange for consideration; they were not for amounts Lowe's was entitled to collect from the buyer on a retail sale.

This Court should affirm the trial court's decision and clarify that contractual payments made by a seller in reimbursement of the bad debt losses incurred by a credit card company do not provide the basis for a sales tax refund under RCW 82.08.037, regardless of whether such payments are deductible as bad debts for federal income tax purposes.

[1] 151 Wn. App. 909, 215 P.3d 222 (2009), *review denied,* 168 Wn.2d 1008, 226 P.3d 781 (2010).

II. COUNTERSTATEMENT OF THE ISSUES

1. Under RCW 82.08.037, a seller may recover the sales taxes it paid on a retail sale if it cannot collect the sale proceeds from the buyer. When a buyer purchased goods from Lowe's using a private label credit card, Lowe's received cash payment of the entire sale proceeds, including sales taxes, from GE Capital. Is Lowe's entitled to a sales tax refund for bad debts that reduced its share of the financing income generated by the private label credit card accounts?

2. Under RCW 82.04.4284, a taxpayer may deduct from the measure of the B&O tax bad debts "on which tax was previously paid." Lowe's did not report or pay B&O taxes on any of the financing income it received under its profit-sharing agreement with GE Capital. Is Lowe's entitled to take a deduction from the measure of the retailing B&O tax for bad debts that reduced the amount of unreported financing income it was entitled to receive from GE Capital?

3. The bad debt sales tax credit and B&O tax deduction statutes distinguish sellers that incur credit losses directly attributable to a retail sale from those contractually agreeing to reimburse the bad debt losses of a third-party lender. Does the disparate tax treatment satisfy the due process and equal protection clauses of the federal constitution?

III. COUNTERSTATEMENT OF THE CASE

Lowe's sold home improvement products at retail stores in Washington during the relevant period. CP 47, 451. When a customer purchased a product, Lowe's accepted payment in the form of cash, check, debit card, or credit card. CP 47. For credit card purchases, a customer could use either a general-use credit card or a Lowe's-labeled credit card. *Id.* A store-branded credit card is known in the credit industry as a "private label credit card." CP 68. A private label credit card is a customized credit card that may be used only at a particular retailer's outlets. CP 37, 211.

A. GE Capital Extended Credit to Lowe's' Customers

Lowe's did not extend credit to its customers on the retail sales for which it claims a refund. CP 41, 49. Lowe's arranged for various banking subsidiaries of the General Electric Capital Corporation (GE Capital) to provide credit to its customers. CP 49, 451. Operating under a license to use the Lowe's brand, GE Capital applied creditworthiness standards to consumer applications for private label credit cards and entered into credit card agreements with these consumers. CP 30, 453.

GE Capital was the "sole and exclusive owner" of all credit accounts, outstanding receivables, and related sales documentation. CP 136 (Section 3.02 Ownership of Accounts). GE Capital had the "sole right to establish the finance charge rates" and "all other terms and conditions" relating to the credit accounts. CP 41, 136. Lowe's agreed it had "no right, title or interest" in the credit accounts and transaction-related documentation. CP 136. The exclusive right to receive payments by the cardholders was "vested in the Bank." *Id.* Their contractual agreement provided that GE Capital "shall be entitled to retain for its account all Program Revenues, if any, *and shall bear all Program Expenses*, with respect to the Accounts and Indebtedness." *Id.* (emphasis added).

Lowe's and GE Capital agreed to jointly market and promote usage of the private label credit card. CP 134. But their contractual agreements specified that all marketing and promotional materials given to customers "clearly disclose that Bank is the owner and creditor on all Accounts[.]" *Id.* Lowes and GE Capital also expressly agreed their relationship was not to be construed as any type of agency. CP 175.

B. Lowe's Received Cash Payment Of The Retail Sale Proceeds

Lowe's accounted for the private label credit card transactions as "cash or cash equivalents," the same as if the customer paid by cash, check or an ordinary credit card. CP 60. Within a day or two of each transaction, GE Capital wired the settlement proceeds to Lowe's' bank account. CP 453. The settlement proceeds included the face amount of the gross sale proceeds, including sales taxes, net of customer refunds, chargebacks, and amounts withheld for joint marketing expenses. CP 145.

When a customer failed to pay its credit card bill, GE Capital, not Lowe's, wrote-off the uncollectible debt on its books and records. CP 126 ("Gross Write-Offs") CP 945. Lowe's' books and records did not reflect any unpaid debt obligations on the defaulted credit card accounts. CP 52, 113, 945. Lowe's did not carry any cardholder accounts as accounts receivables on its books because, as it explained to its investors, "consumer credit is extended directly to customers by" GE Capital, and "[a]ll credit program related services are performed and controlled directly by" GE Capital. CP 49.

C. GE Capital's Bad Debt Write-offs Reduced The Amount Of Additional Financing Income Lowe's Was Entitled To Receive

As an additional incentive to promote usage of the private label credit cards, GE Capital entered into a profit-sharing agreement with Lowe's. CP 66. Under the terms of the agreement, Lowe's was entitled to the excess profits generated by the credit card portfolio once GE Capital reached its "target" rate of return. CP 44, 66, 141. On the other hand, Lowe's agreed it would make up for any shortfalls in GE Capital's target rate of return. CP 41, 44. The revenues generated by the credit card accounts included finance charges, late fees, returned check fees, debt insurance premiums and charges from any other services offered by the Bank. CP 130, 454. Program expenses included various operational costs related to servicing the accounts, including net write-offs. *Id.* GE Capital and Lowe's settled the payment obligations arising from their profit-sharing agreement on a monthly basis. CP 44, 142.

Each year, GE Capital and Lowe's calculated the total anticipated revenues and expenses associated with the private label credit card program and allocated them between the parties. CP 140. Their profit-sharing agreement states that "for this purpose" Lowe's "shall be responsible for Net Write-Offs during such year up to a maximum of 7.0% of Average Net Receivables," with GE Capital responsible for amounts exceeding that limit. *Id.*

GE Capital provided Lowe's a monthly report that itemized all the revenues and expenses related to the private label credit card program. CP 143. GE Capital's net write-offs on the accounts were one of the "program expenses" the parties took into account for purposes of calculating the net amount Lowe's was entitled to receive from (or was required to pay to) GE Capital under the terms of their revenue-sharing agreement. CP 141.

The revenue-sharing agreement was typical of those GE Capital has with other national retailers. CP 66. GE Capital has explained to its investors that it enters into profit-sharing agreements with retailers in order to "align our interests and provide an additional incentive to our partners to promote our credit products." CP 66.

D. The Trial Court Denied Lowe's' Tax Refund Action

The Department conducted successive audits of Lowe's' books and records for the 2001 through 2009 tax period. CP 419, 427. The Department determined that Lowe's had improperly claimed bad debt sales tax credits and bad debt retailing B&O tax deductions on the defaulted private label credit card accounts. *Id.* As a result of the audits, the Department assessed retail sales taxes and retailing B&O taxes on the disallowed bad debt tax credits and deductions.

The Department affirmed the assessments in Determination No. 09-0198R and No. 12-0260. CP 432, 440. Lowe's paid the contested taxes and filed a tax refund claim under RCW 82.32.180 in the Thurston County Superior Court. CP 5. The parties filed cross-motions for summary judgment. CP 1156, 2616. The trial court denied Lowe's' motion for summary judgment and granted the Department's motion for summary judgment. CP 2800.

IV. ARGUMENT

RCW 82.08.037 provides a limited exception to the general rule that a seller is personally liable to the State for failing to collect retail sales taxes from the buyer, without allowance for any business losses the seller incurs on the transaction. The bad debt sales tax credit relieves the seller from personal liability for the sales taxes due on a retail sale if the sale proceeds prove uncollectible and are written-off in the seller's books and records. Under the plain terms of the statute, Lowe's is not entitled to a sales tax refund because it actually collected the sales proceeds from the buyer, including the sales taxes it remitted to the State, when its customers bought goods with a private label credit card issued by GE Capital.

The bad debt deductions Lowe's took on its federal tax returns for its "guaranty payments" in reimbursement of GE Capital's bad debt losses do not provide the basis for a sales tax refund. A guaranty payment is not "written off as uncollectible" in the seller's books and records. A guaranty payment is an amount the seller was *required to pay* in exchange for valuable consideration from a third party lender, not an amount it was *entitled to collect* from the retail buyer. RCW 82.08.037 applies only to uncollectible sale proceeds owed by the buyer to the seller on a retail sale transaction. Bad debts arising from a seller's separate contractual agreement with a credit card company do not qualify.

Whether the bad debt sales tax credit should be extended to bad debts arising from private label credit card accounts is a question of tax policy for the Legislature. Unless the Legislature amends RCW 82.08.037, retailers in Washington may not claim a sales tax refund on bad debts attributable to private label credit card accounts they do not own.

A. The Statutes Authorizing Refunds Of State Excise Taxes Must Be Strictly Construed Against The Taxpayer

This Court applies de novo review to a trial court's summary judgment order. *Cashmere Valley Bank v. Dep't of Revenue*, 181 Wn.2d 622, 631, 334 P.3d 1100 (2014). A question of statutory interpretation is a matter of law also subject to de novo review. *Id.* When possible, "the court derives legislative intent solely from the plain language enacted by the Legislature, considering the text of the provision in question, the context of the statute in which the provision is found, related provisions, amendments to the provision, and the statutory scheme as a whole." *Id.*

Courts presume taxes are valid. *Avnet, Inc. v. Dep't of Revenue*, 187 Wn.2d 44, 50, 384 P.3d 571 (2016). Thus, Lowe's bears the burden of proving an exemption applies. *Id.* (citing RCW 82.32.180). The availability and scope of a tax exemption or deduction is purely a matter of legislative grace. *Home Depot USA, Inc. v. Levin*, 121 Ohio St. 3d 482, 905 N.E.2d 630, 635 (2009). Tax exemptions may not be extended by implication. *TracFone Wireless, Inc. v. Dep't of Revenue*, 170 Wn.2d 273, 296-97, 242 P.3d 810 (2010). To qualify, a taxpayer must demonstrate that it clearly comes within the scope of a tax deduction statute. *Id.* "If there is ambiguity in a provision providing an exemption or deduction, the court must strictly construe the provision against the taxpayer." *Avnet,* 187 Wn.2d at 50.

In applying the State's tax laws, courts "glean legislative intent from the text of the statute, regardless of incidental and contrary agency interpretations." *Tesoro Ref. & Mktg. Co. v. Dep't of Revenue*, 173 Wn.2d 551, 557-58, 269 P.3d 1013 (2012). Thus, the deposition testimony of Department employees regarding their understanding of the law or of Lowe's' contracts is irrelevant and should be disregarded. *See Avnet, Inc. v. Dep't of Revenue*, 187 Wn. App. 427, 437, n. 8, 348 P.3d 1273 (2015) (purportedly inconsistent statements by DOR employees lack relevance), *aff'd by*, 187 Wn.2d 44, 384 P.3d 571 (2016). A tax refund action is a de novo proceeding in which the court applies the law to the facts in the record without regard to what occurred during the audit or administrative appeal proceeding. RCW 82.32.180.

B. RCW 82.08.037 Authorizes A Tax Refund For Sellers That Paid Sales Taxes They Could Not Collect From The Buyer

Washington imposes a retail sales tax on "each retail sale." RCW 82.08.020(1). The tax is based on the "selling price," meaning "the total amount of consideration" for which a good is sold, without deduction for the seller's overhead expenses or "any other expenses whatsoever . . . and without deduction on account of losses." RCW 82.08.010(1)(a)(i); *Klickitat County v. Jenner*, 15 Wn.2d 373, 382, 130 P.2d 880 (1942).

The primary obligation to pay the sales tax is on the buyer, but the seller has the duty to remit the tax even if it collects nothing at the time of sale. RCW 82.08.050(1); *AARO Medical Supplies, Inc. v. Dep't of Revenue*, 132 Wn. App. 709, 717, 132 P.3d 1143 (2006). Sales taxes paid by the seller on behalf of a buyer constitute a "debt" owed by the buyer to the seller. RCW 82.08.050(8); *Home Depot v. Dep't of Revenue*, 151 Wn. App. 909, 917, 215 P.3d 222 (2009). A seller is personally liable to the State for any sales taxes it fails to collect, "whether such failure is the result of his or her own acts or conditions beyond his or her control." RCW 82.08.050(3); *AARO Medical Supplies*, 132 Wn. App. at 716.

In 1982, the Legislature enacted a statute to allow a seller that incurred a credit loss on a retail sale to recover the sales taxes it paid on the buyer's behalf.[2] Laws of 1982, 1st Ex. Sess., ch. 35, § 35. The version of the statute in effect during the tax period at issue provided, in part:

> (1) A seller is entitled to a credit or refund *for sales taxes previously paid on bad debts*, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003[...]

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[2] Until 1982, sellers could not recoup the sales taxes they had paid on a credit sale that proved uncollectible. In *Olympic Motors Inc. v. McCroskey,* 15 Wn.2d 665, 132 P.2d 355 (1942), the Washington Supreme Court declined to infer an allowance for an automobile dealer's credit losses on installment sales contracts, considering the clear legislative intent to disallow deduction for business losses from the sales tax base: "While one may sell his personal property under a conditional sales contract and waive his right to collect the full purchase price at the time of sale . . . that waiver has no effect on the sales tax liability." *Id.* at 669.

Former RCW 82.08.037 (2007) (emphasis added).[3]

RCW 82.08.037 is a "tax preference" that must be construed "no more broadly than necessary to fulfill its legislative purpose." *Home Depot*, 151 Wn. App. at 916 n.3. The legislative purpose of the statute is to provide a remedy for sellers that paid sales taxes they could not collect from the buyer. *Id.* at 917. Nearly all states with a sales tax have a similar provision. *See generally* James Amdur, *Recovery of Sales Taxes Paid on Bad Debts*, 38 A.L.R.6th 255 (2017). Professor Hellerstein, the author of the leading treatise on state tax law, explains the prevailing view:

> The denial of a credit or deduction to retailers who suffer defaults or bad debts with respect to the purchase price (as well as the tax) is harsh and unwarranted...[T]he overwhelming majority of states have abandoned the harsh rules articulated in the earlier cases, and virtually all states allow a credit or refund for bad debts. States typically allow

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[3] Except as stated otherwise, this brief refers to RCW 82.08.037 as amended in 2007. Laws of 2007, ch. 6, § 105. A copy of that statute is appended to this brief. (Appendix A). The current version of RCW 82.08.037 was not in effect during the 2001 through 2009 tax period. The Legislature amended the statute several times during the tax period. In 2003, 2004, and 2007, the Legislature revised RCW 82.08.037 as part of the Streamlined Sales and Use Tax initiative, a multi-state effort to simplify and harmonize the sales tax laws nationwide. *See* Laws of 2003, ch. 168, § 1; Laws of 2004, ch. 153, §§ 302-305; Laws of 2007, ch. 6, § 105. The legislative purpose in amending RCW 82.08.037 was to clarify rather than change the substance of the statute. The Legislature clarified that "debts which are deductible as worthless for federal income tax purposes" refers to "'bad debts,' as that term is used in 26 U.S.C. 166." *Home Depot*, 151 Wn. App. at 913 n.1.

In 2010, the Legislature narrowed RCW 82.08.037 by disallowing sales tax refunds on bad debts arising from credit accounts the seller assigned to a third party. Laws of 2010, 1st Spec. Sess., ch. 23, § 1502. The purpose of the 2010 amendment was to supersede the Supreme Court's decision in *Puget Sound National Bank v. Dep't of Revenue*, 123 Wn.2d 284, 868 P.2d 127 (1994). In *Puget Sound*, the Supreme Court held that a person who acquired by assignment the unpaid customer debt obligations owing to a retailer was entitled to a sales tax refund under RCW 82.08.037 for its bad debt losses on the assigned credit accounts.

> such credits, deductions, or refunds *when the debt becomes worthless and is charged off on the seller's books...*

See Walter Hellerstein & John A. Swain, STATE TAXATION, ¶ 17.18[3] (3d. ed. 2017) (emphasis added).

Bad debts, within the meaning of Section 166 of the Internal Revenue Code, are "worthless debts" that are "owed to the taxpayer." 26 C.F.R. Sec. 1.166-1(a) (copy provided as Appendix B). Only a "bona fide debt" qualifies. A "bona fide debt" is "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable amount of money." *Id.* at (c). The unpaid debt obligation must have previously been reported as income. *Id.* at (e). Bad debts from unpaid fees or unrealized profits do not qualify. *Id.*

According to Lowe's, the availability of a bad debt sales tax refund is "linked exclusively to the federal standard," which allows a bad debt deduction for payments made as the "guarantor" of a third party debt obligation. App. Br. at 39. To the contrary, the availability of a sales tax refund under RCW 82.08.037 is linked to the existence of a bad debt on which sales taxes were previously "paid." Sales taxes are "paid on" the "selling price," which is the contractual consideration the buyer owes to the seller in exchange for the goods sold. RCW 82.08.010(1)(a). Absent an unpaid debt owed by the buyer to the seller on a retail sale transaction, there can be no entitlement to a sales tax refund under RCW 82.08.037.

1. RCW 82.08.037 applies only to amounts "written off as uncollectible" in the seller's books and records.

The Department's tax regulation on bad debts explains that a seller may claim a sales tax credit when "the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes." WAC 458-20-196(2)(a) (copy provided as Appendix C). The tax regulation mirrors the model bad debt rules of the multi-state Streamlined Sales and Use Tax Agreement (SSUTA) (copy provided as Appendix D).[4]

Under the SSUTA's Uniform Rules For Recovery Of Bad Debts, member states must allow a sales tax deduction for amounts "written off as uncollectable" in the "claimant's" books and records.[5] SSUTA, § 320.C. The write-off is "the essence of the bad debt deduction." *In re Hoffman*, 16 F. Supp. 391, 393 (E.D. Penn. 1936). *See* 26 C.F.R. § 1.166-2

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[4] *See* Streamlined Sales and Use Tax Agreement, Adopted November 12, 2002 and amended through May 11, 2017, at http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%202017-5-11.pdf. When the Legislature joined the SSUTA in 2003, it expressed its intent that the State's sales and use tax laws "be interpreted and applied consistently with the agreement." RCW 82.02.210(3).

[5] The SSUTA Commission used the term "claimant" rather than "seller" to accommodate the minority of states that, like Washington, permit a third-party assignee to claim a sales tax refund on unpaid debt obligations originated by a seller that sold goods on credit. *See* Streamlined Sales Tax Project Bad Debt Issue Paper, November 2001, at 1-2, at http://www.streamlinedsalestax.org/uploads/downloads/IP%20Issue%20Papers/2001/IP01001%20Streamlined%20Issue%20Papers%20Nov%202001%20rev%2011_9.pdf.

(debt is "worthless," and, thus, deductible, when it is "charged off" taxpayer's books).

Because Lowe's did not own the accounts receivables from the private label credit card accounts, it had nothing to write off as uncollectible when a cardholder defaulted. Lowe's had "no right, title or interest in the Accounts (including the Indebtedness) created in connection with the Program." CP 145. GE Capital, not Lowe's, wrote off the unpaid credit card debt obligations. CP 945 ("GE owns the receivable and we do not make an entry when an account is uncollectible."). For this reason, this Court and others have rejected retailer claims of entitlement to a sales tax refund on defaulted private label credit card accounts. *Home Depot*, 151 Wn. App. at 922-23; 38 A.L.R.6th 255, § 7.5; *Circuit City Stores, Inc. v. Director of Revenue*, 438 S.W.3d 397, 403 n.10 (Mo. 2014) ("to get a refund the retailer itself must write off the debt").

2. Lowe's does not qualify for a sales tax refund because it actually collected the sales taxes it remitted to the State.

The Department allowed the bad debt sales tax credits and B&O tax deductions Lowe's took for its bad debt losses on bad checks, credit card chargebacks,[6] and credit losses (net of bad debt write-offs attributable

[6] A credit card chargeback is the reversal of a credit card transaction. CP 153. The cardholder's credit card debt obligation is canceled. The seller is required to refund the settlement proceeds it received from the bank. CP 154. This may result from the fraudulent or invalid use of a credit card. CP 939. When a chargeback occurred, GE

to NSF fees, unpaid finance charges, and other incidental expenses). CP 460. But the Department properly disallowed the bad debt sales tax credits and B&O tax deductions Lowe's took on GE Capital's write-offs.[7]

Lowe's did not incur a bad debt loss on the retail sales financed by GE Capital. Lowe's received cash payment of the entire amount it was entitled to collect from the buyer, including the sales taxes. CP 453. Lowe's' so-called "Bad Debt Guarantee" reduced the amount of its monthly "profit-sharing distributions" from GE Capital. CP 453 (Aultman Decl.) at ¶ 14. But it did not impact Lowe's' right to receive the gross proceeds of retail sales charged to private label credit cards, including sales taxes, through the daily settlement process. *Id.* at ¶ 10 ("When a Cardholder purchased merchandise from [Lowes's], the Bank would within a day or two remit payment for the purchases and corresponding taxes to [Lowe's].); CP 144-45 (settlement procedures).

Capital would "assign, without recourse, all right to payment" on the charge slip to Lowe's. CP 154. Lowe's could then proceed directly against the buyer, the same as with a bounced check. *See* CP 962-63 (IRS audit report explaining that upon a bank's refusal to pay a check, Lowe's would reverse the entry it made to its cash account for the face value of the check, record an account receivable for an equivalent amount, and pursue collection of the unpaid debt obligation due from the buyer.

[7] Lowe's suggests the Department's denial of its refund claim on the defaulted private label credit accounts is inconsistent with its allowance of bad debt sales tax credits on chargebacks. App. Br. at 32 n.19. There is no inconsistency. Unlike with a chargeback, the cardholder's failure to pay GE Capital did not result in the reversal of any credit card charges. Lowe's was neither required to refund the settlement proceeds to GE Capital nor entitled to collect the unpaid credit card debt obligations from the buyer. *See* CP 136 (the "primary and exclusive right" to receive payments "with respect to the Indebtedness shall be vested in Bank"). The cardholder's debt obligation to GE Capital remained intact. There was no unpaid debt obligation owed to Lowe's by the buyer.

Lowe's was not entitled to claim bad debt sales tax credits on retail sales for which it was paid in full.

3. Following *Puget Sound*, RCW 82.08.037 applies only to consumer loans made by a seller, not a bank.

The Washington Supreme Court addressed RCW 82.08.037 for the first and only time in *Puget Sound National Bank v. Department of Revenue*, 123 Wn.2d 284, 868 P.2d 127 (1994). *Puget Sound* involved an automobile dealer that sold vehicles to its customers through installment sales contracts. A bank acquired the dealer's unpaid consumer debt obligations by a contract of assignment. When the customers subsequently defaulted on their payment obligations, the bank filed a sales tax refund claim under RCW 82.08.037 for its bad debt losses.

In addressing whether the bank had standing to claim a bad debt sales tax refund, the Supreme Court observed that RCW 82.08.037 applies only to credit losses incurred by a "seller" that engages in "making sales at retail." *Puget Sound*, 123 Wn.2d at 287-88. But the court held that the bank had "stepped into the shoes" of the seller by virtue of the contract of assignment, and it thereby assumed the rights and liabilities associated with the installment sale contracts, including the seller's right to recover the sales taxes it had advanced on the buyer's behalf. *Id.* at 293.

According to Lowe's, *Puget Sound* stands for the proposition that its right to a sales tax refund "is governed entirely by whether the bad debt loss is deductible under IRC § 166." App. Br. at 17. To the contrary, following *Puget Sound*, the requisite basis for a sales tax refund is the existence of an unpaid debt obligation *originated by a seller*. No one disputed the bank properly deducted its credit losses on its federal income tax returns. *Puget Sound*, 123 Wn.2d at 287. If Lowe's were correct that the right to a sales tax refund depends exclusively on whether a bad debt is deductible under IRC § 166, that would have ended the matter.

But the Supreme Court recognized a bank ordinarily cannot claim a sales tax refund for its bad debt losses on consumer loans. The bank qualified only because it assumed the status of the "seller" that had extended credit to the retail buyer. *Puget Sound*, 123 Wn.2d at 293. As the seller's assignee, the bank was entitled to the sales tax refund the seller could have claimed if it had maintained *ownership* of the unpaid debt obligations. *Id.* at 290 ("if the dealers had not assigned their installment contracts to the Bank, the dealers would have been entitled to a sales tax refund under RCW 82.08.037").

Unlike the automobile dealer in *Puget Sound*, Lowe's did not extend credit to its customers. GE Capital did. The credit card loans made by GE Capital do not provide the basis for a sales tax refund under RCW 82.08.037. The Legislature has not seen fit to authorize a sales tax refund for credit card companies that assume the risk of bad debt losses as an ordinary incident of engaging in the business of consumer lending.

RCW 82.08.037 does not by implication extend to sellers that enter into profit-sharing agreements with credit card companies. *Cf. Cashmere Valley Bank*, 181 Wn.2d at 640 (declining to extend by implication a B&O tax deduction for interest derived from home mortgage loans to banks that invest in mortgage-backed securities rather than extending credit directly).

4. Following *Home Depot*, a retailer cannot obtain a sales tax refund on bad debts arising from private label credit card accounts it does not own.

In *Home Depot*, this Court addressed whether a retailer qualified for a sales tax refund under RCW 82.08.037 on bad debts arising from private label credit card accounts owned by GE Capital. 151 Wn. App. 909. Like Lowe's, Home Depot contracted with GE Capital to establish a private label credit card program. GE Capital was the exclusive owner of the accounts, controlled the terms and conditions of credit, bore the risk of all credit losses, and took bad debt deductions on its federal income tax return on defaulted credit accounts. *Id.* at 913. Home Depot had no interest in the accounts or indebtedness the program created. GE Capital paid Home Depot the sale proceeds on a daily basis, minus service fees. The service fees were calculated to cover GE Capital's bad debt losses and other expenses, and were based on an economic analysis of the anticipated revenues and expenses related to the private label credit cards. *Id.* at 914.

In *Home Depot*, this Court held that RCW 82.08.037 impliedly requires the person claiming a sales tax refund to be "the one holding the bad debt as well as the one to whom repayment on such a debt would be made." *Id.* at 922. Home Depot was not entitled to claim a sales tax refund for GE Capital's bad debt losses on the credit card accounts.

This Court further held that Home Depot could not qualify for a sales tax refund by showing it "actually bore the loss" on defaulted credit accounts by contractual payments covering GE Capital's bad debt losses. *Home Depot*, 151 Wn. App. at 923. RCW 82.08.037 applies only to bad debts "directly attributable to" a retail sale. *Id.* at 922. This Court reasoned that allowing sellers to recover sales taxes based on bad debts resulting in indirect economic harm would contravene the clear legislative intent to disallow reductions in the sales tax base for a seller's costs of doing business. *Id.* at 923-24.

The trial court correctly ruled that *Home Depot* is the controlling authority in this case. Like Home Depot, Lowe's did not incur a bad debt loss "directly attributable to" a retail sale. *Home Depot*, 151 Wn. App. at 922. Rather, Lowe's' bad debt expenses were attributable to its collateral agreement with GE Capital to share in the profits and losses from the private label credit card program.

a. The Department did not take an inconsistent position in *Home Depot.*

The misgivings the trial court expressed in its oral ruling, which Lowe's highlights, reflect its concern that the denial of Lowe's' refund claim may be inconsistent with arguments the Department successfully advanced in *Home Depot*. App. Br. at 4-5. There is no inconsistency. Home Depot's primary argument was that the "plain language" of RCW 82.08.037 did not require the seller to be the entity that incurred a deductible bad debt. 151 Wn. App. at 919 n.7. The Department argued, and this Court agreed, the statute impliedly requires the refund claimant to be the person "holding the bad debt as well as the one to whom repayment on such debt would be made." 151 Wn. App. at 921.[8]

But the Department never suggested Home Depot would have qualified for a sales tax refund if it had deducted its payments to GE Capital as bad debts rather than as ordinary expenses on its federal tax returns. To the contrary, the Department's core argument, and the one it maintains here, is that RCW 82.08.037 applies only to unpaid debt obligations owed by the buyer to the seller on a retail sale. 151 Wn. App.

[8] *Home Depot* addressed the original version of RCW 82.08.037. *See* 151 Wn. App. at 913 n.1. However, the parties agreed the Legislature intended to clarify the law, not change it, when it amended the statute to conform with the SSUTA. *Id.* Consistent with that stipulation, this Court looked to case law from SSUTA member states addressing similar retailer claims of entitlement to a sales tax refund on defaulted private label credit accounts. *Id.* at 922-23.

at 923-24. Bad debt deductions taken for anything other than the uncollectible proceeds from a retail sale do not qualify.

b. Lowe's relies on dicta in *Home Depot* that the trial court understandably found confusing.

The trial court's oral ruling also reflects its concern that Lowe's' contractual agreement with GE Capital differed from Home Depot's in ways this Court appeared to have deemed material, at least for purposes of distinguishing *Puget Sound*.[9] *Home Depot*, 151 Wn. App. at 920.

Home Depot argued that *Puget Sound* provided controlling authority in its favor. 151 Wn. App. at 918. This Court distinguished *Puget Sound* by analogizing Home Depot to the dealer in that case:

> Home Depot sold all of its interest in the Home Depot card accounts to GECC. Following *Puget Sound* to its logical conclusion, Home Depot surrendered both its right to deduct these losses as bad debt and the ability to claim a refund for this defaulted debt . . .As a result, Home Depot no longer has the authority to deduct the defaults as bad debt or to seek the sales tax refund.

Home Depot, 151 Wn. App. at 920.

Lowe's' effort to distinguish *Home Depot* primarily relies on this part of the decision. Lowe's argues that unlike in *Home Depot* (a) GE Capital had "recourse" against Lowe's on its bad debts from the credit accounts (up to a capped amount), (b) Lowe's "retained" an ownership

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[9] *See* Verbatim Report of Proceedings (VRP), at 3:18-23 ("[I]t appears that Lowe's has a significant number of persuasive arguments in this case as to why this situation is different from the *Home Depot* situation[...]").

interest in sales tax recoveries, and (c) Lowe's deducted its "guaranty payments" as bad debts on its federal returns. App. Br. at 3-4, 36-37.

The trial court correctly noted this Court's ruling in *Home Depot* that a refund claimant "must be the one holding the bad debt" could not be swept aside as dicta. Verbatim Report of Proceedings (VRP) at 4:12-22. But it is not surprising the trial court found Lowe's' arguments "persuasive" to the extent they aimed to distinguish Lowe's' contracts with GE Capital from those at issue in *Home Depot*. VRP at 3:21-23.

In *Home Depot*, this Court correctly stated Home Depot had no more ownership interest in the private label credit card accounts than did the automobile dealer in *Puget Sound*. But this Court arguably carried the analogy too far in stating Home Depot "sold all of its interest" in the credit accounts. 151 Wn. App. at 920. Unlike the automobile dealer in *Puget Sound*, Home Depot *never* had any ownership interest in the private label credit accounts. GE Capital is the entity that extended credit to the retail buyers. 151 Wn. App. at 913. Because Home Depot did not originate the credit card loan obligations, it had no interest in them to "sell."

This is a critical distinction because the automobile dealer in *Puget Sound* had a basis for a sales tax refund but Home Depot did not. The automobile dealer made credit sales to its customers. It owned the accounts receivables from the retail sales. If the dealer had sold the unpaid debt obligations to the bank "with recourse," it would have retained a right to a sales tax refund if it were called upon to reimburse the bank for its bad debt losses on the assigned credit accounts. *See* RCW 82.08.037(2)(c), (7). But because the dealer sold its accounts receivables "without recourse," it maintained no ownership interest in them. *Puget Sound*, 123 Wn.2d at 296. Because the dealer had no ownership interest in the credit accounts, it *no longer* had any basis for claiming a bad debt sales tax refund.

In contrast, Home Depot *never* had a basis for claiming a sales tax refund on the credit card accounts owned by GE Capital. RCW 82.08.037 does not apply to consumer loans originated by banks (which is why the bank in *Puget Sound* could only qualify by stepping into the shoes of a "seller" that extended credit to the buyer). *See* 123 Wn.2d at 287-88 ("In order for the Bank…to be eligible for a sales tax refund, the assignment of the installment contracts must satisfy the 'making sales at retail' requirement."). Unlike in *Puget Sound*, the right to a sales tax refund never attached to the credit accounts owned by GE Capital. Home Depot could not have qualified for a bad debt refund by agreeing to absorb GE Capital's bad debt losses. Because Home Depot did not extend credit to its customers, it had no potential right to a sales tax refund to "retain" when negotiating the terms and conditions of its contracts with GE Capital.

To the extent this Court's decision in *Home Depot* can be read to the contrary, this Court should clarify that a seller cannot qualify for a sales tax refund under RCW 82.08.037 by contractually agreeing to indemnify a third party lender for its bad debt losses.

c. Variations in the terms and conditions of Lowe's' contract with GE Capital are immaterial.

By its terms, RCW 82.08.037 applies to "sales taxes paid on bad debts." Sales taxes are "paid on" the proceeds of a retail sale. Sales taxes are not "paid on" the proceeds of a credit card loan. Because GE Capital never had a right to a sales tax refund on the uncollectible proceeds of its credit card loan transactions, Lowe's could not have acquired any such right by agreeing to reimburse GE Capital for its bad debt losses.

Variations in the terms and conditions of a seller's agreement with the financial institution providing credit to a seller's customers are immaterial. *See Circuit City Stores*, 438 S.W.3d at 403 n.10 ("While the specifics of the financing agreements between Dillard's and Circuit City and their respective issuing banks vary, they have in common that they are private agreements between companies as to how they will share in profits, losses, or refunds . . . A company's private agreements cannot modify the tax code[.]"); *Washington Imaging Servs. LLC v. Dep't of Revenue*, 171 Wn.2d 548, 556-57, 252 P.3d 885 (2011) (independent contractor could not avoid B&O tax by contractually disclaiming an ownership interest in amounts billed for its services).

Whatever "recourse" GE Capital had against Lowe's on defaulted private label credit accounts is irrelevant. App. Br. at 10, 19. The existence of a "recourse" arrangement is only relevant in addressing whether a seller qualifies for a sales tax refund on accounts receivables it sold or assigned to a third party, as in *Puget Sound. See* RCW 82.08.037(2)(c), (7).

Likewise, Lowe's' contractual right to "any available sales tax deductions" related to GE Capital's bad debt write-offs is a nullity. CP 144. "[T]he rules regarding who must pay the tax and who is entitled to a refund cannot vary depending on what extra-statutory contractual arrangements a particular retailer chooses to make with a bank. It is the retailer that is the seller, and to get a refund the retailer itself must write off the debt." *Circuit City Stores,* 438 S.W.3d at 40, n.10 (rejecting retailer's reliance on contractual agreement with bank regarding allocation of sales tax recoveries). There are no available sales tax deductions for the bad debts arising from the private label credit card accounts.[10]

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[10] At least not in Washington. At the behest of national retailers and financial institutions, several state legislatures have enacted legislation authorizing sales tax refunds on defaulted private label credit card accounts. *See, e.g.,* Wis. Stat. § 77.585 (July 2, 2013); Mich. Comp. Laws § 205.54i (October 1, 2007); Texas Tax Code 151.246(c) (Oct. 1, 1999). But the Department's counsel is not aware of any appellate court in the country that has done so as a matter of judicial construction of a bad debt statute similar to Washington's. In 2017, the Legislature declined to act on a bill that would have extended the scope of the bad debt sales tax statute to retailers that arrange for financial

5. The 2010 amendment to RCW 82.08.037 shows the Legislature never intended to authorize sales tax refunds on credit accounts originated by banks.

In 2010, the Legislature enacted legislation to supersede the *Puget Sound* decision. Laws of 2010, 1st Sp. Sess., ch 23, §§ 1501-03 ("Limiting the Bad Debt Deduction"). The effect of this change was to prevent a third-party assignee from obtaining a sales tax refund on defaulted credit accounts originated by a seller.[11] The 2010 amendment to RCW 82.08.037 makes it clear the Legislature never intended to authorize a sales tax refund on consumer loans originated by banks.

A seller is still entitled to a sales tax refund on credit accounts it assigned to a third-party "with recourse:"

> If the original seller in the transaction that generated the bad debt has sold or assigned the debt instrument to a third-

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institutions to issue private-label credit cards to their customers. *See* S.B. 5910, 65th Leg., Reg. Sess. (Wash. 2017). Instead, the most recent statutory amendment narrowed the scope of RCW 82.08.37. *See* Laws of 2010, 1st Sp. Sess., ch 23, §§ 1501-03 ("Limiting the Bad Debt Deduction").

[11] The *Puget Sound* decision represented the minority view on the assignability of a bad debt sales tax refund. The majority of states that have addressed the issue have strictly construed bad debt refund statutes as applying only to retailers, not third-party assignees of the seller's credit accounts. *Citifinancial Retail Servs, FSB v. Weiss*, 372 Ark. 128, 271 S.W.3d 494, 498-99 (2008). When the Legislature amended RCW 82.08.037 in 2004 to conform with the SSUTA's uniform bad debt rules, it clarified that it did not intend to supersede the *Puget Sound* decision at that time. Laws of 2004, ch. 153 § 301. But the Legislature never indicated an intent to extend the scope of the bad debt sales tax credit beyond the factual circumstances addressed in *Puget Sound.*

Accordingly, the Department consistently has rejected claims that *Puget Sound* requires a liberal interpretation of the bad debt sales tax statute. *See, e.g.,* Det. No. 04-0158, 24 WTD 262 (2005) (retailer not entitled to sales tax refund on defaulted private label credit card loans financed by third-party); Det. No. 01-0175, 23 WTD 55 (2004) (bank that issues and finances private label credit card accounts may not claim a sales tax refund). The Department's published tax determinations are available online at http://taxpedia.dor.wa.gov/zipfiles.aspx.

> party with recourse, the original seller may claim a credit or refund under this section only after the debt instrument is reassigned by the third-party to the original seller.

RCW 82.08.037(7). But the statute disallows sales tax refunds on "[d]ebts sold or assigned by the seller to third parties, where the third-party is without recourse against the seller[.]" RCW 82.08.037(2)(c). It also states: "[n]o person other than the original seller in the transaction that generated the bad debt" is entitled to claim the deduction. RCW 82.08.037(7).

Before and after the 2010 amendment, RCW 82.08.037 applied only to bad debts arising from a *seller's* accounts receivables on a retail sale. Sellers like Home Depot and Lowe's that arranged for a third-party lender to extend credit to their customers have never had a basis for claiming a sales tax refund under RCW 82.08.037.

C. The Bad Debt Deductions Lowe's Took On Its Federal Tax Returns Do Not Provide The Basis For A Sales Tax Refund Under RCW 82.08.037

According to Lowe's, the Department has "different standards from the IRS (and all other SSUTA states) for determining what constitutes a bad debt." App. Br. at 35. To the contrary, like every other SSUTA member state, Washington permits a seller to claim a sales tax refund when a bad debt is "written off as uncollectible" in the seller's books and records. *Compare* WAC 458-20-196(2)(a), *with* SSUTA, § 320.C. And like every other SSUTA member state, Washington prohibits a seller from claiming a sales tax credit for "financing charges or interest," regardless of whether such amounts are deductible as bad debts on a seller's federal income tax returns. *Compare* WAC 458-20-196(2)(a), *with* SSUTA, § 320.B (member states must exclude "financing charges or interest" and other incidental costs from the scope of the deduction).

It is Lowe's that seeks to make Washington an outlier in its application of the bad debt sales tax credit. As the Vermont Supreme Court recently stated, "the overwhelming majority of courts in similar cases involving similar statutes have held that third-party bad debt does not entitle the retailer or creditor to reclaim the sales tax." *Citibank (South Dakota), N.A. v. Dep't of Taxes*, 149 A.3d 149, 155 (Vt. 2016).

1. Lowe's' bad debt deductions were for amounts it was required to pay as a debtor, not amounts it was entitled to collect from the buyer.

Unlike Home Depot, which negotiated a fixed service fee with GE Capital, Lowe's agreed to assume a contingent liability for GE Capital's bad debt losses as compensation for its participation in the private label credit card program. But the "guaranty payments" Lowe's made to GE Capital were no more "directly attributable to" a retail sale than were the service fees paid by Home Depot. *Home Depot*, 151 Wn. App. at 922. Like the service fees, the guaranty payments were amounts paid in exchange for services provided by GE Capital. CP 454.

A guaranty is a contract. *Frontier Bank v. Bingo Investments, LLC*, 191 Wn. App. 43, 53, 361 P.3d 230 (2015). A guaranty payment is deductible as a bad debt for federal tax purposes only if it was in exchange for "reasonable consideration." 26 C.F.R. § 1.166-9(e). As with other contracts, the promise to satisfy a contractual guaranty is not legally binding unless supported by consideration. *Gelco IVM Leasing Co. v. Alger*, 6 Wn. App. 519, 522, 494 P.2d 501 (1972). Lowe's admits its "guaranty payments" were in exchange for various "benefits," including (at least) "reduced tender costs" and "increased sales." CP 454.

The bad debt sales tax statute allows a seller to receive a refund of sales tax paid "if the sale on which it is based went bad and caused the seller to write off the debt." *Circuit City Stores*, 438 S.W.3d at 402. Lowe's' guaranty payments are not amounts it wrote off as uncollectible. As guarantor, a seller is a secondary debtor of the lender, not a creditor of the buyer. *See* 26 C.F.R. § 1.166-9(a) (allowing deduction for "payment" made as the "secondary obligor" upon a debt obligation).

The bad debt deductions Lowe's took on its federal returns were for amounts it was *required to pay* to GE Capital in discharge of its own debt obligation; they were not for amounts Lowe's was *entitled to collect* from the retail buyer. *See Putnam v. Comm'r*, 352 U.S. 82, 88, 77 S. Ct. 175, 1 L. Ed. 2d 144 (1956) ("the guarantor pays the creditor in compliance with the obligation raised by the law from his contract of guaranty"); *Sauter v. Houston Casualty. Co.*, 168 Wn. App. 348, 356, 276 P.3d 35 (2012) (guaranty contract is a collateral agreement involving different parties, separate consideration, and distinct contractual rights).

RCW 82.08.037 cannot reasonably be read as allowing Lowe's to recoup its guaranty payments. The legislative purpose of RCW 82.08.037 is to provide a limited remedy to sellers that paid sales taxes they could not collect from the buyer. *Home Depot*, 151 Wn. App. at 921. That legislative purpose is served by reading "bad debts" as amounts owing to the seller (or the seller's assignee) by the buyer on a retail sale. It is not served by granting a sales tax refund to sellers that contractually agree to reimburse a credit card company for its bad debt losses.

Every retailer accepting a bank-issued credit card pays transaction fees or other charges covering the bank's costs, including its bad debt losses.[12] Such expenses are costs of doing business that cannot be deducted from the measure of the retail sales tax. *Home Depot*, 151 Wn. App. at 924 ("Home Depot's position regarding risk re-allocation would have us allow it to take a sales tax refund for ordinary business

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[12] Retailers that accept credit cards pay a non-negotiable interchange fee and other merchant discount fees to the national credit card associations and banks that process the transactions. *See* Adam J. Levitin, *Priceless? The Economic Costs of Credit Card Merchant Restraints*, 55 UCLA L. Rev. 1321 (2008). The service fees are consideration for convenience, risk management, and guaranteed payment. *Household Retail Services, Inc. v. Comm'r of Revenue*, 448 Mass. 226, 859 N.E.2d 837 (2007).

expenses."). As Lowe's explained to SEC regulators, it "considers the private label credit card a form of payment, similar to accepting MasterCard, Visa or American Express." CP 44. Accordingly, Lowe's accounts for the costs associated with the program the same as "other credit card interchange fees" and payment processing expenses. *Id.*

Allowing Lowe's to recover its "guaranty payments" to GE Capital would contravene clear legislative intent to disallow reductions in the sales tax base for a seller's costs of doing business. *See Home Depot*, 151 Wn. App. at 924; RCW 82.08.010(1)(a)(i) ("selling price").

2. The bad debt deductions represent unrealized profits from Lowe's' revenue-sharing agreement with GE Capital.

The SSUTA bad debt rules require member states to "[u]tilize the federal definition of 'bad debt' in 26 U.S.C. § 166 as the basis for calculating bad debt recovery." SSUTA, § 320.B. However, deductible bad debts attributable to "financing charges or interest" and other incidental expenses and charges related to a retail sale must be excluded from the scope of the bad debt sales tax refund. *Id.*

GE Capital's bad debt losses on the private label credit card accounts were an item of expense that reduced the amount of *financing income* Lowe's was entitled to receive. *See* CP 454 (Aultman Decl., at ¶ 14) (explaining how Lowe's' monthly share of the "profits" from the private label credit card accounts was reduced by GE Capital's bad debt losses). Specifically, Lowe's was entitled to receive the excess profits generated by GE Capital's credit card portfolio, net of GE Capital's bad debt losses and other program expenses. CP 44, 106-07, 142, 950.

Lowe's was free to share in the profits and losses of GE Capital's credit card operations. But it was not free to claim a sales tax refund for the bad debt expenses it assumed under its profit-sharing agreement. "The mere existence of any economic loss to the refund claimant is simply not sufficient" to justify a sales tax refund. *Home Depot*, 151 Wn. App. at 924.

As the Tennessee Court of Appeals recently stated: "The bad debt statute allows a credit for bad debts, not indirect economic loss. The risk that the private label credit card program will be less profitable than anticipated does not qualify as a bad debt." *Sears, Roebuck & Co. v. Comm'r of Revenue,* No. M201402567COAR3CV, 2016 WL 2866141, at *9 (Tenn. Ct. App. May 11, 2016), *application for permission to appeal denied* (Tenn. Sept. 23, 2016).

By its express terms, RCW 82.08.037 applies only to bad debts on which sales taxes were "paid." Sales taxes are not "paid on" financing charges on a credit card loan. WAC 458-20-109(3) (retail sales tax does not apply to financing charges); *Rena-Ware Distributors, Inc. v. State*, 77 Wn.2d 514, 517, 463 P.2d 622 (1970) (financing charges on credit sales "are not in fact a part of the purchase price" of a retail sale transaction). Thus, if Lowe's had itself extended credit to its customers, it could not have claimed a sales tax refund on any bad debt deductions it took for the uncollectible financing income from its credit sales.

Lowe's appears to concede the point. App. Br. at 11 (explaining that it excluded all "late fees, insurance and finance charges" GE wrote-off from the bad debt tax credits and deductions it took on its state excise tax returns). But Lowe's fails to recognize the amounts it deducted as bad debts on its federal tax returns represent the unrealized profits from its profit-sharing agreement with GE Capital. They were not amounts Lowe's was unable to collect from the buyer on its retail sales.

RCW 82.08.037 cannot reasonably be read as entitling Lowe's to a sales tax refund on bad debts attributable to its profit-sharing agreement.

3. The primary rationale of the *Home Depot* decision forecloses Lowe's' "guarantor" theory of entitlement.

Lowe's recognizes that appellate decisions from across the country came to the same conclusions this Court did in *Home Depot,* but it claims they are "all inapplicable to this case." App. Br. at 39. About ten years ago, Home Depot pursued litigation on its sales tax refund claim in a number of states. Most courts denied Home Depot's refund claim for the same reasons this Court did. As Lowe's states, the cases underscore

(1) contract language stating "all credit losses shall be borne by the Bank," and (2) Home Depot's concession that it did not deduct its payments to GE Capital as bad debts on its federal income tax returns. *Id.* at 40-42.

According to Lowe's, the appellate courts denied Home Depot's refund claim for the sole reason that it "was not entitled to and did not write off the defaulted accounts as worthless" under IRC Section 166. App. Br. at 42. It is true Home Depot's lack of a deductible bad debt precluded it from qualifying for a sales tax refund. But it is not true it was the sole reason this Court and others deemed Home Depot ineligible. The primary rationale was that the buyer's debt obligation to Home Depot on a retail sale was discharged in full when it accepted a private label credit card as payment, the same as with any other bank-issued credit card.

Since there was no unpaid debt obligation owing from the buyer to the seller on a retail sale, there could be no entitlement to a sales tax refund for bad debts. *Home Depot*, 151 Wn. App. at 922 ("Home Depot no longer held any 'debt'-either as defined by state law under former RCW 82.08.050 or by federal law under 26 U.S.C. § 166—*directly attributable* to its sales tax payment to DOR") (emphasis added).

Lowe's asserts this Court should "overrule" its decision in *Home Depot* to the extent it disallows bad debt sales tax refunds for deductible bad debts incurred as a guarantor. App. Br. at 39. It reasons that payments made in discharge of a contractual guarantee are deductible as bad debts under Section 166 and, thus, satisfy the "plain language" of the bad debt statutes. To the contrary, the requirement of a bad debt directly attributable to a retail sale inheres in the language of RCW 82.08.037.

The statute applies to "sales taxes paid on bad debts." Sales taxes are "paid on" the gross proceeds of a retail sale transaction. Thus, the "bad debts" that provide the basis for a sales tax credit under RCW 82.08.037 are uncollectible amounts the buyer owes to the seller in exchange for the goods sold. The deductible bad debt of a guarantor is not an amount the buyer owes to the seller on a retail sale: it is an amount paid in satisfaction of the seller's own debt obligation to the creditor. 26 C.F.R. § 1.166-9(a).

Instead of overruling *Home Depot* as Lowe's requests, this Court should clarify that bad debts arising from a seller's contractual agreement to reimburse bad debt losses incurred by a third party lender do not provide the basis for a sales tax refund under RCW 82.08.037.

4. The favorable ruling Lowe's received from the Oklahoma Tax Commission is not persuasive.

Lowe's submits as persuasive authority a favorable ruling it received in an administrative proceeding before the Oklahoma Tax Commission.[13] App. Br. at 43. In that proceeding, the taxing authority

[13] Decisions by the Oklahoma Tax Commission that favor the taxpayer are not subject to judicial review. *See* Okla. Admin. Code § 710:1-5-42(a) (only the "aggrieved"

stipulated that Lowe's "wrote-off" the "PLCC Bad Debts" on its books and records and properly deducted the bad debts on its federal tax returns. CP 1103. In view of these stipulations, the Administrative Law Judge (ALJ) found the agency's denial of Lowe's' refund claim "contradictory and confusing." CP 1123. The ruling is not persuasive.

The facts in the record establish the bad debts for which Lowe's claims a sales tax refund were not, in fact, "written off as uncollectible" in its books. GE Capital wrote off the bad debts. CP 945. The ALJ in Oklahoma failed to discern the distinction, which Lowe's obscured (as it does here) by using the term "PLCC Bad Debts" to equate its guaranty payments with GE Capital's bad debt write-offs. App. Br. at 45.

Lowes and GE Capital are separate persons for tax purposes. The revenues and expenses related to their separate business activities cannot be conflated as if Lowe's and GE Capital were "acting as a unit." *See Home Depot*, 151 Wn. App. at 925 (in administering private label credit card program seller and bank were "two separate companies bound only by a negotiated contract," not "acting as a unit" for tax purposes).

The ALJ in Oklahoma also assigned undue significance to an IRS audit report that ordered no adjustments to Lowe's' federal income tax

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taxpayer may appeal). Thus, the ALJ's decision has not been reviewed by an Oklahoma appellate court. The Department's counsel is not aware of any appellate decision in the country that has endorsed Lowe's' guaranty theory of entitlement to a bad debt sales tax refund on private label credit card accounts.

liability for the bad debt deductions it took for payments to GE Capital. Lowe's originally deducted the payments as "other deductions" but it filed amended returns to re-characterize them as "bad debts." CP 939. The IRS auditors had no basis for ordering any adjustments because the change had no impact whatsoever on Lowe's' federal income tax liability.[14]

More importantly, the Oklahoma ALJ deemed it immaterial that the bad debt deductions Lowe's took were not directly attributable to a retail sale. In the ALJ's view, the "plain and unambiguous" language of the refund statute imposes no such requirement. App. Br. at 45. In *Home Depot*, this Court came to a different conclusion in view of the text of the statute as a whole and related statutory provisions. 151 Wn. App. at 924.

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[14] For a corporation, bad debts are fully deductible against ordinary income, the same as with "other" deductions. 26 U.S.C. § 166(a); 8 *Mertens Law of Fed. Income Tax'n* § 30:22 (2017); *In re Mills*, 189 B.R. 707, 710 (Bankr. W.D. Tenn. 1995). The distinction between a bad debt and "other deduction" is important when there is a dispute over *when* a deductible expense occurred. *See* CP 1028 (disallowing as premature Lowe's bad debt deductions on bounced checks). A bad debt is a specific type of business expense that becomes deductible only when it is deemed "worthless" under federal criteria. The distinction is not relevant to a guaranty payment. A bad debt arising from a contractual guaranty is deemed worthless, and thus fully deductible, at the time of payment, the same as with any "other" deductible business expense. 26 C.F.R. § 1.166-9(a); *Horne v. Comm'r*, 523 F.2d 1363, 1365 (9th Cir. 1975).

Allowing guaranty payments to provide the basis for a sales tax refund on bad debts would expand the scope of RCW 82.08.037 far beyond retailers that incurred credit losses on retail sale transactions. Virtually any contractual payment measured, in whole or part, by third-party bad debt losses, could be characterized as either an ordinary expense or a bad debt. *See Washington Machinery & Supply Co. v. Zucker*, 19 Wn.2d 377, 380-81, 143 P.2d 294 (1943) (a guarantor is free to limit its liability to a specific amount or percentage of the unpaid obligation of principal debtor). For example, Home Depot could have justified taking bad debt deductions for the service fees it paid to GE Capital for the same reasons Lowe's did: it entered into the private label credit card agreements in a transaction for trade or profit; the fees it paid to GE Capital were in exchange for reasonable consideration; and, the underlying debt obligations the payments were intended to cover were bona fide debts. *See* 26 C.F.R. § 1.166-9(d), (e).

The Washington Board of Tax Appeals also has provided a more nuanced and persuasive analysis than did the Oklahoma Tax Commission in addressing the scope of the bad debt refund statute. *Kohl's Department Stores, Inc. v. Dep't of Revenue*, Bd. Tax. App. Docket No. 13-107 (June 10, 2016).[15] Like Lowe's does, Kohl's Department Store argued it was entitled to a sales tax refund as the "guarantor" of its customers' unpaid private label credit card debts. *Id.* at 8. Kohl's based its claim on a revenue-sharing agreement with the financial institution that issued and owned the credit accounts. Under the agreement, Kohl's was entitled to receive a share of the financing income from the credit card portfolio net of the bad debt losses (and other expenses) incurred by the bank. Kohl's presented expert testimony to establish that it was entitled to take a bad debt deduction on its federal tax returns for its "guaranty payments."

The BTA deemed Kohl's' refund claim "foreclosed" by the *Home Depot* decision. *Kohl's Dep't Stores*, BTA No. 13-107 at 7-8. Following *Home Depot*, Kohl's was not entitled to a sales tax refund on the private label credit accounts because it "held no bad debt warranting a remedy:"

> [T]he Board cannot conclude that, because the service fee that the Taxpayer receives is a percentage of Chase's net financing income (reflecting losses on bad debts), the Taxpayer itself has experienced a bad debt loss within the

[15] The BTA's decision currently is under review in *Kohl's Department Stores, Inc v. State of Washington, Department of Revenue*, Thurston County Superior Court, No. 16-2-02650-34.

> meaning of RCW 82.08.037 or RCW 82.04.4284. The loss that the Taxpayer claims is not a loss on its retail sale transactions; rather, it is a reduction inherent in its [revenue-sharing agreement].

Id.

The BTA correctly recognized that the revenues and expenses (including bad debts) related to Kohl's' revenue-sharing agreement with the bank did not provide the basis for a bad debt sales tax refund under RCW 82.08.037. And as in *Kohl's*, the deductible bad debts Lowe's incurred under its revenue-sharing agreement with GE Capital do not represent bad debt losses on its retail sales. Lowe's was not entitled to recoup its lost profits from GE Capital's credit card operations by claiming a sales tax refund on retail sales for which it was paid in full.

5. Even if its "guarantor" theory were tenable, Lowe's could not prove the "correct amount" of the tax.

A taxpayer that claims a refund must prove not only that it paid more taxes than it owed, but also "the correct amount of the tax." RCW 82.32.180; *Texaco Ref. & Mktg., Inc. v. Dep't of Revenue*, 131 Wn. App. 385, 397-98, 127 P.3d 771 (2006). A taxpayer cannot meet this burden if it fails to segregate taxable revenue from non-taxable revenue. *Tidewater Terminal Co. v. State*, 60 Wn.2d 155, 163, 372 P.2d 674 (1962). Even assuming Lowe's' guaranty payments could provide the basis for a sales tax refund, Lowe's could not establish the "correct amount" of the refund.

In *Automobile Club of Washington v. Department of Revenue*, 27 Wn. App. 781, 621 P.2d 760 (1980), a non-profit organization sought a refund of B&O taxes under an exemption for "bona fide dues." *Id.* at 786-87. Some of the amounts the taxpayer collected from its members qualified as deductible dues, but a substantial portion were paid in exchange for taxable services. This Court held that the taxpayer's failure to segregate the taxable portions of its gross receipts precluded it from meeting its burden of proof, stating: "[a]bsent such a segregation, the Department may presume that the entire amount is taxable." *Id.*

As in *Automobile Club*, Lowe's cannot meet its burden of proof because its guaranty payments were in exchange for valuable services it received from GE Capital. Lowe's could not have deducted the payments as bad debts on its federal returns if it were otherwise. *See* 26 C.F.R. § 1.166-9(e)(1) (taxpayer must demonstrate it received "reasonable consideration" in exchange for its guaranty payment).

The guaranty payments compensated GE Capital for its role in processing the private label credit card charges. Credit card transaction fees and other payment processing expenses are non-deductible costs of doing business. *See* RCW 82.08.010(1); *Central Hardware Co. v. Director of Revenue*, 887 S.W.2d 593, 595 (Mo. 1994); *Home Depot*, 151 Wn. App. at 923-24. Lowe's' inability to segregate the amounts it paid in exchange for "benefits" such as "reduced tender costs" and "increased sales" from amounts attributable to uncollectible sale proceeds precludes it from proving the "correct amount" of the sales tax refund it claims. CP 454.

Further, the monthly reports on which Lowe's bases its refund claim did not take account of the financing income GE Capital had already collected on the credit accounts before its cardholders defaulted. Taxpayers must exclude amounts previously received from the scope of the bad debt credit or deduction. WAC 458-20-196(5). There is no evidence in the record accounting for the financing income Lowe's previously received. It is entirely possible GE Capital received more than the principal amount of the credit card loans from interest charges, late fees, and NSF charges before it wrote off a cardholder account.[16]

As a result of such intractable problems of proof, the refund claim Lowe's filed in Oklahoma stalled in its tracks even though the Oklahoma Tax Commission accepted Lowe's' "guarantor" theory of entitlement. On remand, Lowe's was unable to disentangle the amounts it paid in exchange for consideration and the amounts previously collected in finance fees from the "guaranty payments" for which it claimed a refund. CP 2751.

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[16] *See* Corkery and Silver-Greenberg, *Profits from Store-branded Credit Cards Hide Depth of Retailer Troubles*, New York Times, May 11, 2017 (discussing national retailers' increasing reliance on the "rich profit stream" generated by high interest rates on store-branded credit cards to offset declining earnings from retail sales), *available at* https://www.nytimes.com/2017/05/11/business/dealbook/retailer-credit-cards-macys-losses.html (last viewed August 28, 2017).

D. Whether The Bad Debt Statute Should Be Extended To Retailers That Contract With Credit Card Companies Is A Question Of Tax Policy For The Legislature

During the 2017 legislative session, a bill was introduced in the Washington Legislature that would have allowed retailers to claim a sales tax refund on bad debts attributable to private label credit accounts. S.B. 5910, 65th Leg., Reg. Sess. (Wash. 2017) (Appendix E). The stated purpose of Senate Bill 5910 was "to fix a current inequity in Washington state law," described as follows:

> Under current law, if a customer who uses a credit card owned by the retailer fails to pay their bill, the retailer is entitled to a credit or refund of the sales tax. However, if that same customer uses a private label credit card, neither the retailer nor the private label credit card company is entitled to a credit or refund of the tax.

S.B. 5910, § 1.

The proposed legislation would have redefined "bad debt" to include "amounts due on the accounts or receivables that are charged off on the books and records of the lender." S.B. 5910, § 2(8). The fiscal note estimated the amendment would affect approximately 250 retailers who currently are "responsible for" the "unpaid sales taxes" their customers owe to private label credit card companies. Fiscal Note for S.B. 5910, 65th Leg., Reg. Sess. (Wash. 2017). If enacted, S.B. 5910 would have had an estimated fiscal impact of $18 to $22 million in annual revenue losses from 2017 through 2021. *Id.*

The House Ways and Means Committee did not hold a hearing on S.B. 5910 during the 2017 legislative session. Unless and until such legislation is enacted, retailers in Washington may not claim a sales tax refund on defaulted private label credit card accounts they do not own.

E. RCW 82.04.4284 Does Not Allow A Retailer To Offset Its Retailing B&O Tax Liability By Bad Debts That Reduced Its Financing Income

Washington taxpayers have been permitted to take a B&O tax deduction for their "credit losses" on taxable business transactions since the B&O tax was first enacted in 1935. Laws of 1935, ch. 180, § 12(d). The current version of the B&O tax deduction for bad debts provides:

> 1) In computing tax there may be deducted from the measure of the tax *bad debts*, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003, *on which tax was previously paid*. . .

RCW 82.04.4284 (emphasis added) (Appendix F).

The B&O tax applies to "virtually all business activities carried on within the state." *Steven Klein, Inc. v. Dep't of Revenue*, 183 Wn.2d 889, 896, 357 P.3d 59 (2015) (citations omitted). Various rates apply depending on the type of business activity the taxpayer engages in. *Id.* at 897. For those making retail sales, the retailing B&O tax applies at the rate of .471 percent of "the gross proceeds of sales of the business." RCW 82.04.250(1). Taxpayers that provide financial services, including loan origination and servicing credit accounts, pay B&O tax at the "service and other activities" rate of 1.5 percent of the "gross income of the business." *Nordstrom Credit, Inc. v. Dep't of Revenue*, 120 Wn.2d 935, 938, 845 P.2d 1331 (1993); RCW 82.04.290(2)(a); WAC 458-20-109(2).

Taxpayers with multiple revenue streams are required to report their gross receipts and to pay B&O tax on each separate taxable category of business activity. A retailer that enters into installment sales contracts with its customers pays retailing B&O tax on the "selling price" of the goods sold, and service & other B&O tax on its financing income from the consumer loan transaction. *Rena-Ware*, 77 Wn.2d 514.

The statutory deductions from the B&O tax, likewise, apply to each category of business activity. A taxpayer cannot "mix or match" its taxable revenues and deductible expenses for B&O tax purposes. In *Rena-Ware*, for example, the Supreme Court held that a taxpayer was required to pay service and other B&O tax on its financing income from installment sales contracts even though the underlying retail sale transactions qualified for an exemption from the retailing B&O tax. 77 Wn.2d 514. And in *Klein Honda*, a car dealer could not treat incentive payments it received from a manufacturer for meeting sales goals as a "discount" from the wholesale price of the vehicles it sold to consumers. 183 Wn.2d at 895. Rather, the dealer owed service and other B&O tax on its additional source of income.

Lowe's claims it is entitled to deduct the bad debts it incurred under its revenue-sharing agreement with GE Capital against the measure of the retailing B&O tax. By its express terms, RCW 82.08.4284 authorizes a B&O tax deduction for bad debts "on which tax was previously paid." Lowe's paid retailing B&O taxes on retail sale proceeds it actually received, not on bad debts. In its books and records, Lowe's recorded the private label credit card transactions as "cash or cash equivalents," the same as with ordinary credit card transactions. CP 60.

Lowe's never recorded an account receivable from the buyer on the retail sales transactions financed by GE Capital. CP 113 (Aultman Dep.) ("GE/Synchrony has the receivables and liabilities, along with anything else on their books, and Lowe's does not have a receivable or liability on its books and records at all."); CP 945. Lowe's was not entitled to deduct bad debts that reduced its unreported *financing* income from the measure of the *retailing* B&O taxes it owed on its retail sales.

The activity of financing and servicing credit accounts is a separate and distinct taxable activity for B&O tax purposes from the activity of making retail sales. *See Nordstrom Credit*, 120 Wn.2d at 940 ("The State may levy separate B&O taxes on both the 'sale at retail' and the related service charge income."); *Dep't of Revenue v. J.C. Penney Co., Inc.*, 96 Wn.2d 38, 633 P.2d 870 (1981) (servicing credit accounts for retail customers is a separate taxable activity from the underlying retail sale transactions); *Rena-Ware*, 77 Wn.2d 514 (financing charges imposed on credit sales "are not in fact a part of the purchase price" of a retail sale).

Gross income derived from consumer lending activities is subject to the service and other activities tax rate. RCW 82.04.290(2)(a); WAC 458-20-109(2) ("Persons who receive finance charges, carrying charges, service charges, penalties, and interest are taxable under the service and other business activities classification on the receipt of amounts from these sources."). Lowe's was free to enter into a revenue-sharing agreement with GE Capital. But because it did not report any gross income or pay B&O taxes on its share of the financing income generated by GE Capital's credit card portfolio, Lowe's was not entitled to claim a B&O tax deduction for bad debts it incurred under its revenue-sharing agreement.

F. Denying A Bad Debt Sales Tax Refund To Retailers That Did Not Make Credit Sales Does Not Offend Equal Protection Under the Federal Constitution

Lowe's relies on the *Allegheny Pittsburgh Coal Co. v. Cty. Comm'n of Webster Cty., W. Va.*, 488 U.S. 336, 109 S. Ct. 633, 102 L. Ed. 2d 688 (1989), for the proposition that disparate tax treatment among taxpayers the Legislature intended to treat equally violates the equal protection clause. App. Br. at 46-47.[17] According to Lowe's, the Department arbitrarily imposed an "ownership requirement" that does not exist in the bad debt tax statutes. *Id.* But as this Court recognized in *Home Depot*, RCW 82.08.037 impliedly requires that the person claiming a sales tax refund is the person that holds and owns the unpaid debt obligation on a retail sale. 151 Wn. App. at 922. Retailers that arrange for a financial institution to extend credit to their customers do not qualify.

It is well-established the Legislature has broad discretion in creating tax classifications. *Home Depot*, 151 Wn. App. at 926. An equal protection challenge to disparate tax treatment will fail where "any state of facts can reasonably be conceived that would sustain the classification." *Id.* (citations omitted). A tax classification based on reasonable factual distinctions and policy preferences does not violate equal protection. The differences underlying disparate taxation need not be great. *Lehnhausen v. Lake Shore Auto Parts*, 410 U.S. 356, 93 S. Ct. 1001, 35 L. Ed. 2d 351 (1973) (distinguishing personal property owned by individuals from that owned by "non-individuals"); *Clerk v. Dwyer*, 56 Wn.2d 425, 435, 353 P.2d 941 (1960) (distinguishing green apples from red ones).

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[17] Lowe's did not allege a violation of its federal constitutional right to due process in its amended complaint. CP 15. Thus, its due process argument should be disregarded. *See* RCW 82.32.180 (requiring taxpayer to state "the reason why the tax should be reduced or abated" in its notice of appeal). In any event, the disparate tax treatment no more violates due process than it does equal protection. *See Home Depot*, 151 Wn. App. at 929 (summarily dismissing retailer's due process challenge).

Washington's bad debt tax statutes provide a tax benefit to retailers that paid state excise taxes on taxable sale proceeds they could not actually collect from the buyer. The statutes distinguish sellers who extend credit to their customers and incur bad debts from those that pay contractual fees to a third-party lender to finance and service consumer credit accounts. In *Home Depot*, this Court found that the factual differences between these two "methods of business" amply support the distinction drawn by the Legislature. 151 Wn. App. at 928 ("the two types of financing arrangements include different types of risks, in that, for example, Home Depot receives instant (re)payment from [the Bank] on all accounts, while a self-financing retailer does not").

Contrary to Lowe's' assertion, it is not in the same class as "retailers that paid sales taxes they cannot actually collect from the buyer." App. Br. at 47. Lowe's *did* collect the sale taxes from the buyer, the same as with ordinary credit card transactions. The payments Lowe's made in reimbursement of GE Capital's bad debts were in exchange for valuable consideration and, thus, cannot be equated with the uncompensated losses of a seller that extended credit to its customers. *See Home Depot*, 905 N.E.2d at 634 ("the differing treatment of a vendor that extends credit itself and a vendor that hires a finance company to extend credit fully comports with equal protection").

V. CONCLUSION

Lowe's is not entitled to a sales tax refund under RCW 82.08.037 because it did not incur a bad debt loss on the retail sales for which it claims a refund. The bad debt deductions Lowe's took on its federal tax returns were for amounts it paid in satisfaction of its *own* debt obligation to GE Capital; they were not for amounts Lowe's was entitled to collect from the buyer in exchange for taxable goods or services. The buyer's debt obligation to Lowe's on a retail sale was discharged in full when Lowe's accepted a private label credit card as payment.

Accordingly, this Court should affirm the trial court's summary judgment order, reaffirm its decision in *Home Depot*, and clarify that bad debts attributable to a contractual payment by a seller to a third party lender do not provide the basis for a refund of sales taxes or retailing B&O taxes under RCW 82.08.037 or RCW 82.04.4284, respectively.

RESPECTFULLY SUBMITTED this 28th day of August, 2017.

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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 28th day of August, 2017, at Tumwater, WA.

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APPENDIX A

apply to sales of cigarettes by an Indian retailer during the effective period of a cigarette tax contract subject to RCW 43.06.455 or a cigarette tax agreement under RCW 43.06.465 or 43.06.466. [2008 c 228 § 3; 2005 c 11 § 3; 2001 c 235 § 4.]

Authorization for agreement—Effective date—2008 c 228: See notes following RCW 43.06.466.

Findings—Intent—Explanatory statement—Effective date—2005 c 11: See notes following RCW 43.06.465.

Intent—Finding—2001 c 235: See RCW 43.06.450.

82.08.032 Exemption—Sales, rental, or lease of used park model trailers. The tax imposed by RCW 82.08.020 shall not apply to:

(1) Sales of used park model trailers, as defined in RCW 82.45.032;

(2) The renting or leasing of used park model trailers, as defined in RCW 82.45.032, when the rental agreement or lease exceeds thirty days in duration. [2001 c 282 § 3.]

Intent—2001 c 282: "It is the intent of the legislature to promote fairness in the application of tax. Therefore, for the purposes of excise tax, park model trailers will be taxed in the same manner as mobile homes." [2001 c 282 § 1.]

Effective date—2001 c 282: "This act takes effect August 1, 2001." [2001 c 282 § 5.]

82.08.033 Exemptions—Sales of used mobile homes or rental or lease of mobile homes. The tax imposed by RCW 82.08.020 shall not apply to:

(1) Sales of used mobile homes as defined in RCW 82.45.032.

(2) The renting or leasing of mobile homes if the rental agreement or lease exceeds thirty days in duration and if the rental or lease of such mobile home is not conducted jointly with the provision of short-term lodging for transients. [1986 c 211 § 2; 1979 ex.s. c 266 § 3.]

82.08.034 Exemptions—Sales of used floating homes or rental or lease of used floating homes. The tax imposed by RCW 82.08.020 shall not apply to:

(1) Sales of used floating homes, as defined in RCW 82.45.032;

(2) The renting or leasing of used floating homes, as defined in RCW 82.45.032, when the rental agreement or lease exceeds thirty days in duration. [1984 c 192 § 3.]

82.08.035 Exemption for pollution control facilities. See chapter 82.34 RCW.

82.08.036 Exemptions—Vehicle battery core deposits or credits—Replacement vehicle tire fees—"Core deposits or credits" defined. The tax levied by RCW 82.08.020 shall not apply to consideration: (1) Received as core deposits or credits in a retail or wholesale sale; or (2) received or collected upon the sale of a new replacement vehicle tire as a fee imposed under RCW 70.95.510. For purposes of this section, the term "core deposits or credits" means the amount representing the value of returnable products such as batteries, starters, brakes, and other products with returnable value added for the purpose of recycling or remanufacturing. [1989 c 431 § 45.]

Severability—Section captions not law—1989 c 431: See RCW 70.95.901 and 70.95.902.

82.08.037 Credits and refunds for bad debts. (1) A seller is entitled to a credit or refund for sales taxes previously paid on bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003.

(2) For purposes of this section, "bad debts" does not include:

(a) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;

(b) Expenses incurred in attempting to collect debt; and

(c) Repossessed property.

(3) If a credit or refund of sales tax is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount collected must be paid and reported on the return filed for the period in which the collection is made.

(4) Payments on a previously claimed bad debt are applied first proportionally to the taxable price of the property or service and the sales or use tax thereon, and secondly to interest, service charges, and any other charges.

(5) If the seller uses a certified service provider as defined in RCW 82.32.020 to administer its sales tax responsibilities, the certified service provider may claim, on behalf of the seller, the credit or refund allowed by this section. The certified service provider must credit or refund the full amount received to the seller.

(6) The department shall allow an allocation of bad debts among member states to the streamlined sales tax agreement, as defined in RCW 82.58.010(1), if the books and records of the person claiming bad debts support the allocation. [2007 c 6 § 102; 2004 c 153 § 302; 2003 c 168 § 212; 1982 1st ex.s. c 35 § 35.]

Part headings not law—Savings—Effective date—Severability—2007 c 6: See notes following RCW 82.32.020.

Findings—Intent—2007 c 6: See note following RCW 82.14.495.

Bad debts—Intent—2004 c 153 §§ 302-305: "For the purposes of sections 302 through 305 of this act, the legislature does not intend by any provision of this act relating to bad debts, and did not intend by any provision of chapter 168, Laws of 2003 relating to bad debts, to affect the holding of the supreme court of the state of Washington in *Puget Sound National Bank v. the Department of Revenue,* 123 Wn. 2nd 284 (1994)." [2004 c 153 § 301.]

Retroactive effective date—Effective date—2004 c 153: See note following RCW 82.08.0293.

Effective dates—Part headings not law—2003 c 168: See notes following RCW 82.08.010.

Severability—Effective dates—1982 1st ex.s. c 35: See notes following RCW 82.08.020.

82.08.040 Consignee, factor, bailee, auctioneer deemed seller. Every consignee, bailee, factor, or auctioneer authorized, engaged, or employed to sell or call for bids on tangible personal property belonging to another, and so selling or calling, shall be deemed the seller of such tangible personal property within the meaning of this chapter and all sales made by such persons are subject to its provisions even though the sale would have been exempt from tax hereunder had it been made directly by the owner of the property sold. Every consignee, bailee, factor, or auctioneer shall collect and remit the amount of tax due under this chapter with respect to sales made or called by him: PROVIDED, That if the owner of the property sold is engaged in the business of

APPENDIX B

Q–6 Does a commodities dealer or person regularly engaged in investing in regulated futures contracts qualify for the profit presumption for all transactions?

A–6 No. The presumption is only applicable to regulated futures contract transactions in property that is the subject of the person's regular trading activity. For example, a commodities dealer who regularly trades only in agricultural futures will not qualify for the presumption for a silver futures straddle transaction. For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Code as in effect before the enactment of the Tax Reform Act of 1984.

Q–7 Who qualifies as a commodities dealer or as a person regularly engaged in investing in regulated futures contracts for purposes of the profit presumption?

A–7 For purposes of this section, the term "commodities dealer" has the meaning given to such term by section 1402(i)(2)(B) of the Code. Section 1402(i)(2)(B) defines a commodities dealer as a person who is actively engaged in trading section 1256 contracts (which includes regulated futures contracts as defined in Q&A–6) and is registered with a domestic board of trade which is designated as a contract market by the Commodity Futures Trading Commission. To determine if a person is regularly engaged in investing in regulated futures contracts all the facts and circumstances should be considered including, but not limited to, the following factors: (1) Regularity of trading at all times throughout the year; (2) the level of transaction costs; (3) substantial volume and economic consequences of trading at all times throughout the year; (4) percentage of time dedicated to commodity trading activities as compared to other activities; and (5) the person's knowledge of the regulated futures contract market.

Q–8 If a commodities dealer or a person regularly engaged in investing in regulated futures contracts participates in a syndicate, as defined in section 1256(e)(3)(B) of the Code, does the rebuttable presumption of "entered into for profit" apply to the transactions entered into through the syndicate?

A–8 No. A participant in a syndicate does not qualify for the rebuttable presumption of "entered into for profit" with respect to transactions entered into by or for the syndicate. A syndicate is defined in section 1256(e)(3)(B) of the Code as any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)).

Q–9 Will the Service continue to make the closed and completed transaction argument set forth in Rev. Rul. 77–185, 1977–1 C.B. 48, with respect to transactions covered by section 108 of the Act?

A–9 No. The closed and completed transaction argument will not be made regarding transactions subject to section 108 of the Act. In general, losses in such transactions will be allowed for the taxable year of disposition if the transaction is not viewed as a sham and satisfies the "entered into for profit" test described in Q&A–2. Nevertheless, for certain positions covered by section 108 of the Act, various Code sections may apply without regard to whether such position constitutes a straddle to disallow or limit the loss otherwise allowable in the year of the disposition. For example, dispositions of certain positions held by a partnership which resulted in a loss to a partner may be limited or disallowed under section 465 of 704(d).

[T.D. 7968, 49 FR 33445, Aug. 23, 1984]

§ 1.166–1 Bad debts.

(a) *Allowance of deduction.* Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) *Manner of selecting method.* (1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

(2) Taxpayers who have properly selected one of the two methods for treating bad debts under provisions of prior law corresponding to section 166 shall continue to use that method for all subsequent taxable years unless the Commissioner grants permission to use the other method.

(3)(i) For taxable years beginning after December 31, 1959, application for permission to change the method of treating bad debts shall be made in accordance with section 446(e) and paragraph (e)(3) of § 1.446–1.

(ii) For taxable years beginning before January 1, 1960, application for permission to change the method of treating bad debts shall be made at least 30 days before the close of the taxable year for which the change is effective.

(4) Nothwithstanding paragraphs (b) (1), (2), and (3) of this section, a dealer in property currently employing the accrual method of accounting and currently maintaining a reserve for bad debts under section 166(c) (which may have included guaranteed debt obligations described in section 166(f)(1)(A)) may establish a reserve for section 166(f)(1)(A) guaranteed debt obligations for a taxable year ending after October 21, 1965 under section 166(f) and § 1.166–10 by filing on or before April 17, 1986 an amended return indicating that such a reserve has been established. The establishment of such a reserve will not be considered a change in method of accounting for purposes of section 446(e). However, an election by a taxpayer to establish a reserve for bad debts under section 166(c) shall be treated as a change in method of accounting. See also § 1.166–4, relating to reserve for bad debts, and § 1.166–10, relating to reserve for guaranteed debt obligations.

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A debt arising out of the receivables of an accrual method taxpayer is deemed to be an enforceable obligation for purposes of the preceding sentence to the extent that the income such debt represents have been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year. For example, a debt arising out of gambling receivables that are unenforceable under state or local law, which an accrual method taxpayer includes in income under section 61, is an enforceable obligation for purposes of this pargarph. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt its not due at the time of deduction shall not of itself prevent is allowance under section 166. For the disallowance of deductions for bad debts owed by a political party, see § 1.271–1.

(d) *Amount deductible*—(1) *General rule.* Except in the case of a deduction for a reasonable addition to a reserve for bad debts, the basis for determining the amount of deduction under section 166 in respect of a bad debt shall be the same as the adjusted basis prescribed by § 1.1011–1 for determining the loss from the sale or other disposition of property. To determine the allowable deduction in the case of obligations acquired before March 1, 1913, see also paragraph (b) of § 1.1053–1.

(2) *Specific cases.* Subject to any provision of section 166 and the regulations thereunder which provides to the contrary, the following amounts are deductible as bad debts:

(i) *Notes or accounts receivable.* (*a*) If, in computing taxable income, a taxpayer values his notes or accounts receivable at their fair market value when received, the amount deductible as a bad debt under section 166 in respect of such receivables shall be limited to such fair market value even though it is less than their face value.

(*b*) A purchaser of accounts receivable which become worthless during the taxable year shall be entitled under section 166 to a deduction which is based upon the price he paid for such receivables but not upon their face value.

(ii) *Bankruptcy claim.* Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted under section 166 as a bad debt.

(iii) *Claim against decedent's estate.* The excess of the amount of the claim over the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate may be considered a worthless debt under section 166.

(e) *Prior inclusion in income required.* Worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income shall not be allowed as a deduction under section 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.

(f) *Recovery of bad debts.* Any amount attributable to the recovery during the taxable year of a bad debt, or of a part of a bad debt, which was allowed as a deduction from gross income in a prior taxable year shall be included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of §1.111–1, relating to the recovery of certain items previously deducted or credited. This paragraph shall not apply, however, to a bad debt which was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts.

(g) *Worthless securities.* (1) Section 166 and the regulations thereunder do not apply to a debt which is evidenced by a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. See section 166(e). For provisions allowing the deduction of a loss resulting from the worthlessness of such a debt, see §1.165–5.

(2) The provisions of subparagraph (1) of this paragraph do not apply to any loss sustained by a bank and resulting from the worthlessness of a security described in section 165(g)(2)(C). See paragraph (a) of §1.582–1.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7902, 48 FR 33260, July 21, 1983; T.D. 8071, 51 FR 2479, Jan. 17, 1986]

§ 1.166–2 Evidence of worthlessness.

(a) *General rule.* In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

(b) *Legal action not required.* Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

(c) *Bankruptcy*—(1) *General rule.* Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt.

(2) *Year of deduction.* In bankruptcy cases a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year.

(d) *Banks and other regulated corporations*—(1) *Worthlessness presumed in year of charge-off.* If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either—

APPENDIX C

WAC 458-20-196

Bad debts.

(1) **Introduction.**

This section provides information about the tax treatment of bad debts under the business and occupation (B&O), public utility, retail sales, and use taxes.

(a) **Bad debt deduction for accrual basis taxpayers.** Bad debt credits, refunds, and deductions occur when income reported by a taxpayer is not received. Taxpayers who report using the cash method do not report income until it is received. For this reason, bad debts are most relevant to taxpayers reporting income on an accrual basis. However, some transactions must be reported on an accrual basis by all taxpayers, including installment sales and leases. These transactions are eligible for a bad debt credit, refund, or deduction as described in this section. For information on cash and accrual accounting methods, refer to WAC **458-20-197** (When tax liability arises) and WAC **458-20-199** (Accounting methods). Refer to WAC **458-20-198** (Installment sales, method of reporting) and WAC **458-20-199**(3) for information about reporting installment sales.

(b) **Relationship between retailing B&O tax deduction and retail sales tax credit.** Generally, a retail sales tax credit for bad debts is reported as a deduction from the measure of sales tax on the excise tax return. The amount of this deduction, or the measure of a recovery of sales tax that must be reported, may differ from the amount reported as a deduction or recovery from the retailing B&O tax classification due to exempt sales (for example: Sales of motor vehicles and trailers for use in interstate or foreign commerce (RCW **82.08.0263**); sales of manufacturing machinery and equipment (RCW **82.08.02565**).)

(c) **Relationship to federal income tax return.** Washington credits, refunds, and deductions for bad debts are based on federal standards for worthlessness under section 166 of the Internal Revenue Code. If a federal income tax return is not required to be filed (for example, where the taxpayer is an exempt entity for federal purposes), the taxpayer is eligible for a bad debt credit, refund, or deduction on the Washington tax return if the taxpayer would otherwise be eligible for the federal bad debt deduction.

(2) **Retail sales and use tax.**

(a) **General rule.** Under RCW **82.08.037** and **82.12.037**, sellers are entitled to a credit or refund for sales and use taxes previously paid on "bad debts" under section 166 of the Internal Revenue Code, as amended or renumbered as of January 1, 2003. Taxpayers may claim the credit or refund for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes. However, "bad debts" do not include:

(i) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;

(ii) Expenses incurred in attempting to collect debt;

(iii) Debts sold or assigned by the seller to third parties, where the third party is without recourse against the seller (see (c) of this subsection for additional information about this restriction); and

(iv) The value of repossessed property taken in payment of debt.

(b) **Recoveries.** If a taxpayer takes a credit or refund for sales or use taxes paid on a bad debt and later collects some or all of the debt, the amount of sales or use tax recovered must be repaid in the tax-reporting period during which collection was made. The amount of tax that must be repaid is determined by applying the recovered amount first proportionally to the taxable price of the property or service and the sales or use tax thereon and secondly to any interest, service charges, and any other charges.

(c) **Assigned debt and installment sales.** Effective July 1, 2010, RCW **82.08.037** and **82.12.037** limit who can claim a credit or refund for retail sales or use tax. Only the original seller in the transaction that generated the bad debt, or a certified service provider (CSP) used by the seller, is entitled to claim a credit or refund on or after July 1, 2010. If the original seller in the transaction that generated the bad debt has sold or assigned the debt instrument to a third party with recourse, the original seller may claim a credit or refund only after the debt instrument is reassigned by the third party to the original seller. In the case where the seller uses a CSP to administer its sales tax responsibilities the CSP may claim, on behalf of the seller, the credit or refund allowed. See chapter 23, Laws of 2010, 1st sp. sess., (2ESSB 6143).

(3) **Business and occupation tax.**

(a) **General rule.** Under RCW **82.04.4284**, taxpayers may deduct from the measure of B&O tax "bad debts" under section 166 of the Internal Revenue Code, as amended or renumbered as of January 1, 2003, on which tax was previously paid. Taxpayers may claim the deduction for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes. However, the amount of the deduction must be adjusted to exclude amounts attributable to:

(i) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;

(ii) Sales or use taxes payable to a seller;

(iii) Expenses incurred in attempting to collect debt; and

(iv) The value of repossessed property taken in payment of debt.

(b) **Recoveries.** Recoveries received by a taxpayer after a bad debt is claimed are applied under the rules described in subsection (2)(b) of this section if the transaction involved is a retail sale. The amount attributable to "taxable price" is reported under the retailing B&O tax classification. If the recovery of debt is not related to a retail sale, recovered amount is applied proportionally against the components of the debt (e.g., interest and principal remaining on a wholesale sale).

(c) **Extracting and manufacturing classifications.** Bad debt deductions are only allowed under the extracting or manufacturing classifications when the value of products is computed on the basis of gross proceeds of sales.

(4) **Public utility tax.** Under RCW **82.16.050**(5), taxpayers may deduct from the measure of public utility tax "bad debts" under section 166 of the Internal Revenue Code, as amended or renumbered as of January 1, 2003, on which tax was previously paid. Taxpayers may claim the deduction for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes. No deduction is allowed for collection or other expenses.

(5) **Application of payments - General rule.** The special rules for application of payments received in recovery of previously claimed bad debts described in subsections (2)(b) and (3)(b) of this section are not used for other payments. Payments received before a bad debt credit, refund, or deduction is claimed should be applied first against interest and then ratably against other charges. Another commercially reasonable method may be used if approved by the department.

(6) **Private label credit cards.** If a business contracts with a financial company to provide a private label credit card program, and the financial company becomes the exclusive owner of the credit card accounts and solely bears the risk of all credit losses, the business that contracted with the financial company is not entitled to any bad debt deduction if a customer fails to pay his or her credit card invoice.

Example. Hot Shot Ski Equipment (Hot Shot) is a sporting equipment retailer. Hot Shot contracts with ABC Financial Institution (ABC) to issue a Hot Shot private label credit card. ABC has the authority to accept or reject an applicant's credit card application. After Hot Shot transmits the credit card sales records to ABC, ABC pays Hot Shot the proceeds of the sales including the retail sales tax minus any applicable service fees. Hot Shot remits the retail sales tax to the Department of Revenue. If a customer using the Hot Shot credit card fails to pay ABC the outstanding amount on the credit card invoice, ABC suffers the loss. Hot Shot is not entitled to a bad debt deduction or credit as it has no bad debt loss when a customer defaults on a debt to ABC.

(7) **Reserve method.** Ordinarily, taxpayers must report bad debt refunds, credits or deductions for specifically identified transactions. However, taxpayers who are allowed by the Internal Revenue Service to use a reserve method of reporting bad debts for federal income tax purposes, or who secure permission from the department to do so, may deduct a reasonable addition to a reserve for bad debts. What constitutes a reasonable addition to a reserve for bad debts must be determined in light of the facts and will vary between classes of business and with conditions of business prosperity. An addition to a reserve allowed as a deduction by the Internal Revenue Service for federal income tax purposes, in the absence of evidence to the contrary, will be presumed reasonable. When the reserve method is employed, an adjustment to the amount of loss deducted must be made annually to make the total loss claimed for the tax year coincide with the amount actually sustained.

(8) **Statute of limitations for claiming bad debts.** No credit, refund, or deduction, as applicable, may be claimed for debt that became eligible for a bad debt deduction for federal income tax purposes more than four years before the beginning of the calendar year in which the credit, refund, or deduction is claimed.

(9) **Examples.** The following examples identify a number of facts and then state a conclusion. These examples should be used only as a general guide. The tax results of other situations must be determined after a review of all of the facts and circumstances.

In all cases, an eight percent combined state and local sales tax rate is assumed. Figures are rounded to the nearest dollar. Payments are applied first against interest and then ratably against the taxable price, sales tax, and other charges except when the special rules for subsequent recoveries on a bad debt apply (see subsections (2) and (3) of this section). It is assumed that the income from all retail sales described has been properly reported under the retailing B&O tax classification and that all interest or service fees described have been accrued and reported under the service and other activities B&O tax classification.

(a) **Scenario 1.** Joe's Hardware makes a retail sale of goods with a selling price of $500 and pays $40 in sales tax to the department. No payment is received by Joe at the time of sale.

(i) Bad debt. One and a half years later, no payment has been received by Joe, and the balance with interest is $627. Joe is entitled to claim a bad debt deduction on his federal income tax return. He is also entitled to claim a bad debt sales tax credit or refund in the amount of $40, a B&O tax deduction of $500 under the retailing B&O tax classification, and a B&O tax deduction of $87 under the service and other activities B&O tax classification.

(ii) Recoveries. Six months after the credit and deduction are claimed, a $50 payment is received on the debt. Recoveries received on a retail sale after a credit and deduction have already been claimed must be applied first proportionally to the taxable price and sales tax thereon in order to determine the amount of tax that must be repaid. Therefore, Joe must report $4, or $50 x ($40/$540), of sales tax on the current excise tax return and $46, or $50 x ($500/$540) under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original $40 credit for sales tax is reduced to zero.

(b) **Scenario 2.** Joe makes a retail sale of goods on credit for $500 and pays $40 in sales tax to the department. No payment is received at the time of sale. Over the following year, regular payments are received and the debt is reduced to $345, exclusive of any interest or service charges. The $345 represents sales tax due to Joe in the amount of $26, or $345 x ($40/$540), and $319 remaining of the original purchase price, or $345 x ($500/$540). Payments cease.

(i) Bad debt. Six months later the balance with interest and service fees is $413. Joe is entitled to claim a bad debt deduction on the federal income tax return. He is also entitled to claim a sales tax refund or credit on the current excise tax return of $26, a deduction under the retailing B&O tax classification of $319, and a deduction under the service and other activities B&O tax classification of $68.

(ii) Recoveries. Before Joe charges off the debt, he repossesses the goods. At that time, the goods have a fair market value of $250. No credit is allowed for repossessed property, so the value of the collateral must be applied against the outstanding balance. After the value of the collateral is applied, Joe has a remaining balance of $163, or $413 - $250. The allocation rules for recoveries do not apply because a bad debt credit or refund has not yet been taken. The value is applied first against the $68, or $413 - $345, of interest, so the $163 remaining is attributable entirely to taxable price and sales tax. Any costs Joe may incur related to locating, repossessing, storing, or selling the goods do not offset the value of the collateral because no credit is allowed for collection costs. Joe is entitled to a sales tax refund or credit in the amount of $12, or $163 x ($40/$540) and deduction of $151, or $163 x ($500/$540) under the retailing B&O tax classification.

(iii) Sales of repossessed goods. If Joe later sells the repossessed goods, he must pay B&O tax and collect retail sales tax as applicable. If the sales price of the repossessed goods is different from the fair market value previously reported and the statute of limitations applicable to the original transaction has not expired, Joe must report the difference between the selling price and the claimed fair market value as an additional bad debt credit or deduction or report it as an additional recovery, as appropriate.

(c) **Scenario 3.** Phil, of Phil's Fine Cars, sells a car at retail for $1000 and charges Alice, the buyer, an additional $50 for license and registration fees.

(i) Trade-in accepted. Phil accepts trade-in property with a value of $500 in which Alice has $300 of equity. (The value of trade-in property of like kind is excluded from the selling price for purposes of the retail sales tax. Refer to WAC **458-20-247** for further information.) Phil properly bills Alice for $40 of sales tax, for a total of $1090 owed to Phil by Alice. Phil pays the department the $40 in sales tax. No payment other than the trade-in is received by Phil at the time of sale.

(ii) Bad debt. Eight months later, Phil has not received any payment. Phil is entitled to claim a bad debt deduction on his federal income tax return. The equity in the trade-in is equivalent to a payment received at the time of purchase, reducing the balance remaining on the initial sale to $790, or $1090 - $300. Phil is entitled to claim a sales tax credit or refund of

$29, or $790 x ($40/$1090) of sales tax, and a deduction of $725, or $790 x ($1000/$1090) under the retailing B&O tax classification, exclusive of any deduction for accrued interest.

(d) **Scenario 4.** Phil sells a car at retail for $1000, and charges Jake an additional $50 for license and registration fees. Phil properly bills Jake for $80 of sales tax and remits it to the department. No money is received from Jake at the time of sale.

(i) Bad debt. Eight months later Phil is entitled to claim a bad debt deduction on the federal income tax return. Phil claims an $80 sales tax credit, a $1000 retailing B&O tax deduction, and an additional amount under the service and other activities classification for accrued interest.

(ii) Recoveries. Six months after claiming a bad debt, Phil receives a $200 payment from Jake. Recoveries must be allocated first proportionally to the taxable price (the measure of the sales tax) and the sales tax thereon, and secondly to other charges. B&O tax consequences follow the same rules. Accordingly, Phil must report $15, or $200 x ($80/$1080) of sales tax and $185, or $200 x ($1000/$1080) of income under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original $80 sales tax credit is reduced to zero.

(e) **Scenario 5.** Phil sells a car at retail for $1000, and charges Robin an additional $50 for license and registration fees.

(i) Trade-in accepted. Phil accepts trade-in property with a value of $500 in which Robin has $300 of equity. Phil properly bills Robin for $40 of sales tax for a total of $1090 owed to Phil by Robin. No payment other than the trade-in is received by Phil at the time of sale.

(ii) Bad debt. Eight months later, no payment has been received by Phil. Phil is entitled to claim a bad debt deduction on the federal income tax return. The equity in the trade-in is equivalent to a payment received at the time of purchase, reducing the balance remaining on the initial sale to $790, or $1090 - $300. Phil is entitled to claim a sales tax credit or refund of $29, or $790 x ($40/$1090) of sales tax, and a deduction of $725, or $790 x ($1000/$1090) under the retailing B&O tax classification, exclusive of any deduction for accrued interest.

(iii) Recoveries. Six months after that, Phil receives a $200 payment from Robin. Recoveries must be allocated first proportionally to the taxable price (the measure of the sales tax) and sales tax thereon, and secondly to other charges. B&O tax consequences follow the same rules. Accordingly, Phil must report $15, or $200 x ($40/$540) in sales tax, and $185, or $200 x ($500/$540) under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original $29 sales tax credit is reduced to zero.

(f) **Scenario 6.** The facts are the same as in Scenario 3 (c) of this subsection, except that immediately after the sale, Phil assigns the contract to a finance company without recourse, receiving face value for the contract. The finance company may not claim the retail sales tax credit or refund. The finance company may not claim any deductions for Phil's B&O tax liability. No bad debt deduction or credit is available to Phil, as the contract was sold without recourse.

[Statutory Authority: RCW **82.32.300**, **82.01.060**(2), **82.08.037**, and **82.12.037**. WSR 10-21-012, § 458-20-196, filed 10/7/10, effective 11/7/10. Statutory Authority: RCW **82.32.300** and **82.01.060**(2). WSR 06-01-005, § 458-20-196, filed 12/8/05, effective 1/8/06. Statutory Authority: RCW **82.32.300**, **82.01.060**(1), and **34.05.230**. WSR 05-04-048, § 458-20-196, filed 1/27/05, effective 2/27/05. Statutory Authority: RCW **82.32.300**. WSR 83-07-032 (Order ET 83-15), § 458-20-196, filed 3/15/83; Order ET 70-3, § 458-20-196 (Rule 196), filed 5/29/70, effective 7/1/70.]

APPENDIX D

Section 320: UNIFORM RULES FOR RECOVERY OF BAD DEBTS

Each member state shall use the following to provide a deduction for bad debts to a seller. To the extent a member state provides a bad debt deduction to any other party, the same procedures will apply. Each member state shall:

A. Allow a deduction from taxable sales for bad debts. Any deduction taken that is attributed to bad debts shall not include interest.

B. Utilize the federal definition of "bad debt" in 26 U.S.C. Sec. 166 as the basis for calculating bad debt recovery. However, the amount calculated pursuant to 26 U.S.C. Sec. 166 shall be adjusted to exclude: financing charges or interest; sales or use taxes charged on the purchase price; uncollectable amounts on property that remain in the possession of the seller until the full purchase price is paid; expenses incurred in attempting to collect any debt, and repossessed property.

C. Allow bad debts to be deducted on the return for the period during which the bad debt is written off as uncollectable in the claimant's books and records and is eligible to be deducted for federal income tax purposes. For purposes of this subsection, a claimant who is not required to file federal income tax returns may deduct a bad debt on a return filed for the period in which the bad debt is written off as uncollectable in the claimant's books and records and would be eligible for a bad debt deduction for federal income tax purposes if the claimant was required to file a federal income tax return.

D. Require that, if a deduction is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount so collected must be paid and reported on the return filed for the period in which the collection is made.

E. Provide that, when the amount of bad debt exceeds the amount of taxable sales for the period during which the bad debt is written off, a refund claim may be filed within the member state's otherwise applicable statute of limitations for refund claims; however, the statute of limitations shall be measured from the due date of the return on which the bad debt could first be claimed.

F. Where filing responsibilities have been assumed by a CSP, allow the service provider to claim, on behalf of the seller, any bad debt allowance provided by this section. The CSP must credit or refund the full amount of any bad debt allowance or refund received to the seller.

G. Provide that, for the purposes of reporting a payment received on a previously claimed bad debt, any payments made on a debt or account are applied first proportionally to the taxable price of the property or service and the sales tax thereon, and secondly to interest, service charges, and any other charges.

H. In situations where the books and records of the party claiming the bad debt allowance support an allocation of the bad debts among the member states, permit the allocation.

APPENDIX E

S-1164.1

SENATE BILL 5910

State of Washington 65th Legislature 2017 Regular Session

By Senators Wilson, Keiser, Honeyford, Conway, Hunt, and Rossi

AN ACT Relating to the sales tax credit or refund for amounts charged off as bad debts with respect to private label credit accounts; amending RCW 82.08.037; and creating new sections.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

NEW SECTION. **Sec. 1.** (1) This section is the tax preference performance statement for the tax preference in section 2 of this act. This performance statement is only intended to be used for subsequent evaluation of the tax preference. It is not intended to create a private right of action by any party or be used to determine eligibility for preferential tax treatment.

(2) The legislature categorizes this tax preference as one intended to accomplish a general purpose as indicated in RCW 82.32.808(2)(f).

(3) It is the legislature's specific public policy objective to fix a current inequity in Washington state law. The sales tax is imposed on the customer; the retailer is only supposed to collect the tax from the customer and remit it to the state. Under current law, if a customer who uses a credit card owned by the retailer fails to pay their bill, the retailer is entitled to a credit or refund of the sales tax. However, if that same customer uses a private label credit card, neither the retailer nor the private label credit card company

is entitled to a credit or refund of the tax. The legislature finds that this unfairly makes the retailer and/or private label credit card company the guarantor of the public's tax responsibility.

(4) To measure the effectiveness of the exemption provided in this act in achieving the specific public policy objective described in subsection (3) of this section, the joint legislative audit and review committee must evaluate this tax preference. In order to obtain the data necessary to perform the evaluation in this subsection, the joint legislative audit and review committee may refer to data provided to the department of revenue.

Sec. 2. RCW 82.08.037 and 2010 1st sp.s. c 23 s 1502 are each amended to read as follows:

(1) A seller is entitled to a credit or refund for sales taxes previously paid on bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003.

(2) For purposes of this section, "bad debts" does not include:

(a) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;

(b) Expenses incurred in attempting to collect debt;

(c) Except as provided in subsection (8) of this section, debts sold or assigned by the seller to third parties, where the third party is without recourse against the seller; and

(d) Repossessed property.

(3) If a credit or refund of sales tax is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount collected must be paid and reported on the return filed for the period in which the collection is made.

(4) Payments on a previously claimed bad debt are applied first proportionally to the taxable price of the property or service and the sales or use tax thereon, and secondly to interest, service charges, and any other charges.

(5) If the seller uses a certified service provider as defined in RCW 82.32.020 to administer its sales tax responsibilities, the certified service provider may claim, on behalf of the seller, the credit or refund allowed by this section. The certified service provider must credit or refund the full amount received to the seller.

(6) The department must allow an allocation of bad debts among ((~~member states to the streamlined sales tax agreement, as defined in~~

~~RCW 82.58.010(1)~~)) states, if the books and records of the person claiming bad debts support the allocation.

(7) A person's right to claim a credit or refund under this section is not assignable. No person other than the original seller in the transaction that generated the bad debt or, as provided in subsection (5) of this section, a certified service provider, is entitled to claim a credit or refund under this section. If the original seller in the transaction that generated the bad debt has sold or assigned the debt instrument to a third party with recourse, the original seller may claim a credit or refund under this section only after the debt instrument is reassigned by the third party to the original seller.

(8) Notwithstanding the other provisions of this section, the following applies for amounts charged off with respect to private label credit accounts:

(a) A seller may claim a credit or refund of the tax previously reported by the seller on the unpaid balance due on the accounts or receivables that are charged off as a bad debt on the books and records of the lender, and the accounts or receivables have been charged off as bad debts on the lender's books and records on or after July 1, 2017.

(b) The credit or refund for the accounts or receivables must include all credit sale transaction amounts outstanding in the account or receivable at the time the account or receivable is charged off, regardless of the date on which the credit sale transaction actually occurred.

(c) For purposes of this subsection (8):

(i) "Bad debt" means amounts due on the accounts or receivables that are charged off on the books and records of the lender;

(ii) "Lender" means a person or an affiliate, assignee, or transferee of a person, that owns a private label credit account, or an interest in a private label credit account receivable, provided that interest was any of the following:

(A) Transferred from a third party;

(B) Purchased directly from a seller that remitted tax imposed under this chapter or from an affiliate of the seller; or

(C) Originated according to a written agreement between the person and a seller that remitted tax imposed under this chapter or an affiliate of the seller; and

(iii) "Private label credit account" means a credit account or credit card that carries, refers to, or is branded with the name or logo of a seller, and can be used for purchases from the seller whose name or logo appears on the card or account, or for purchases from any of the seller's affiliates. This subsection does not authorize any credit or refund with respect to sales by any person other than the seller whose name or logo appears on the card or account, or any of the seller's affiliates.

(d) If a seller claims a credit or refund of sales tax under this subsection (8) and the seller or the lender subsequently collects all or part of the bad debt, then the seller must pay the tax on the amount collected in accordance with subsection (3) of this section.

NEW SECTION. **Sec. 3.** Section 2 of this act is exempt from the automatic expiration date provisions of RCW 82.32.805(1)(a).

--- END ---

APPENDIX F

the deductibility of investment income for business and occupation tax purposes. As a result, the legislature directed the department of revenue to work with affected businesses to develop a revision of the statute that would provide certainty and stability for taxpayers and the state. The legislature intends, by adopting this recommended revision of the statute, to provide a positive environment for capital investment in this state, while continuing to treat similarly situated taxpayers fairly." [2002 c 150 § 1.]

Effective date—2002 c 150: "This act takes effect July 1, 2002." [2002 c 150 § 3.]

Finding—Intent on application of deduction—2001 c 320: "The legislature finds that the application of the business and occupation tax deduction provided in RCW 82.04.4281 for investment income of persons other than those engaging in banking, loan, security, or other financial businesses has been the subject of disagreement between taxpayers and the state. Decisions of the supreme court have provided some broad guidelines and principles for interpretation of the deduction provided in RCW 82.04.4281, but these decisions have not provided the certainty and clarity that is desired by taxpayers and the state. Therefore, it is the intent of the legislature to delay change in the manner or extent of taxation of the investment income until definitions or standards can be developed and enacted by the legislature." [2001 c 320 § 18.]

Reviser's note: 2001 c 320 § 19, which was vetoed May 15, 2001, would have implemented the intent in this section.

Report to legislature—2001 c 320: "The department of revenue shall report to the fiscal committees of the legislature by November 30, 2001, on the progress made in working with affected businesses on potential amendments to RCW 82.04.4281 which would clarify the application of RCW 82.04.4281 to other financial businesses." [2001 c 320 § 20.]

Intent—1980 c 37: "The separation of sales tax exemption, use tax exemption, and business and occupation deduction sections into shorter sections is intended to improve the readability and facilitate the future amendment of these sections. This separation shall not change the meaning of any of the exemptions or deductions involved." [1980 c 37 § 1.]

82.04.4282 Deductions—Fees, dues, charges. In computing tax there may be deducted from the measure of tax amounts derived from bona fide (1) initiation fees, (2) dues, (3) contributions, (4) donations, (5) tuition fees, (6) charges made by a nonprofit trade or professional organization for attending or occupying space at a trade show, convention, or educational seminar sponsored by the nonprofit trade or professional organization, which trade show, convention, or educational seminar is not open to the general public, (7) charges made for operation of privately operated kindergartens, and (8) endowment funds. This section shall not be construed to exempt any person, association, or society from tax liability upon selling tangible personal property or upon providing facilities or services for which a special charge is made to members or others. If dues are in exchange for any significant amount of goods or services rendered by the recipient thereof to members without any additional charge to the member, or if the dues are graduated upon the amount of goods or services rendered, the value of such goods or services shall not be considered as a deduction under this section. [1994 c 124 § 3; 1989 c 392 § 1; 1980 c 37 § 3. Formerly RCW 82.04.430(2).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4283 Deductions—Cash discount taken by purchaser. In computing tax there may be deducted from the measure of tax the amount of cash discount actually taken by the purchaser. This deduction is not allowed in arriving at the taxable amount under the extractive or manufacturing classifications with respect to articles produced or manufactured, the reported values of which, for the purposes of this tax, have been computed according to the provisions of RCW 82.04.450. [1980 c 37 § 4. Formerly RCW 82.04.430(3).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4284 Deductions—Bad debts. (1) In computing tax there may be deducted from the measure of tax bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003, on which tax was previously paid.

(2) For purposes of this section, "bad debts" do not include:

(a) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;

(b) Expenses incurred in attempting to collect debt;

(c) Sales or use taxes payable to a seller; and

(d) Repossessed property.

(3) If a deduction is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount collected must be paid and reported on the return filed for the period in which the collection is made.

(4) Payments on a previously claimed bad debt must be applied under RCW 82.08.037(4) and 82.12.037, according to such rules as the department may prescribe. [2004 c 153 § 307; 1980 c 37 § 5. Formerly RCW 82.04.430(4).]

Retroactive effective date—Effective date—2004 c 153: See note following RCW 82.08.0293.

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4285 Deductions—Motor vehicle fuel and special fuel taxes. In computing tax there may be deducted from the measure of tax so much of the sale price of motor vehicle fuel as constitutes the amount of tax imposed by the state under chapters 82.36 and 82.38 RCW or the United States government, under 26 U.S.C., Subtitle D, chapters 31 and 32, upon the sale thereof. [1998 c 176 § 3; 1980 c 37 § 6. Formerly RCW 82.04.430(5).]

Rules—Findings—Effective date—1998 c 176: See RCW 82.36.800, 82.36.900, and 82.36.901.

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4286 Deductions—Nontaxable business. In computing tax there may be deducted from the measure of tax amounts derived from business which the state is prohibited from taxing under the Constitution of this state or the Constitution or laws of the United States. [1980 c 37 § 7. Formerly RCW 82.04.430(6).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4287 Deductions—Compensation for receiving, washing, etc., horticultural products for person exempt under RCW 82.04.330—Materials and supplies used. In computing tax there may be deducted from the measure of tax amounts derived by any person as compensation for the receiving, washing, sorting, and packing of fresh perishable horticultural products and the material and supplies used therein when performed for the person exempted in RCW 82.04.330, either as agent or as independent contractor. [1980 c 37 § 8. Formerly RCW 82.04.430(7).]

Intent—1980 c 37: See note following RCW 82.04.4281.

ATTORNEY GENERAL'S OFFICE - REVENUE & FINANCE DIVISION

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